To Appoint or Not Appoint When Managing Bankruptcy

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To Appoint or Not To Appoint a Trustee in Bankruptcy

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LEGAL STANDARDS FOR APPOINTMENT OF A TRUSTEE

Section 1104(a) of the Bankruptcy Code authorizes the appointment of a trustee (1) "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor," (2) "if such appointment is in the best interests of creditors, any equity security holders, and other interests of the estate," or (3) if grounds exist for dismissal of the case or conversion to chapter 7, but the court determines that the appointment of a trustee is in the best interests of creditors and the estate. 11 U.S.C. § 1104(a).

- The appointment of a trustee should be the exception, rather than the rule.
    - *In re Sharon Steel Corp.*, 871 F.2d 1217, 1225 (3d Cir. 1989)
    - *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 471 (3d Cir. 1998)
- The standard for § 1104 appointment is very high.
    - *Smart World Techs., LLC. v. Juno Online Servs., Inc. (In re Smart World Techs., LLC)*, 423 F.3d 166, 176 (2d Cir. 2005)
- The appointment of a chapter 11 trustee represents an "extraordinary remedy."
    - *In re Ionosphere Clubs, Inc.*, 113 B.R. 164, 167 (Bankr. S.D.N.Y. 1990)
    - *In re Adelphia Communications Corp.*, 336 B.R. 610, 658 (Bankr. S.D.N.Y. 2006), *aff'd*, 342 B.R. 122 (S.D.N.Y. 2006)
- Majority case law suggests that movant must prove the need for a trustee by clear and convincing evidence.
    - *Sharon Steel*, 871 F.2d at 1226
    - *Marvel*, 140 F.3d at 471
    - *Adelphia*, 336 B.R. at 656
    - *Official Committee of Asbestos Claimants v. G-I Holdings, Inc. (In re G-I Holdings, Inc.)*, 385 F.3d 313, 317-318 (3d Cir. 2004)

- Minority case law suggests that the burden is by a preponderance of the evidence.
    - *Tradex Corp. v. Morse*, 339 B.R. 823, 829–32 (D. Mass. 2006)
    - *In re Altman*, 230 B.R. 6, 16-17 (Bankr. D. Conn. 1999), *vacated in part on other grounds*, 254 B.R. 509 (D. Conn. 2000)
- There is "a strong presumption" against the appointment of a trustee.
    - *Ionosphere*, 113 R.R. at 167
    - *Marvel*, 140 F.3d at 471
- Basis for the aforementioned "strong presumption"
    - The debtor-in-possession is already a fiduciary for the estate and has an obligation to refrain from acting in a manner that could damage the estate.
    - The debtor-in-possession's usual familiarity with the business it had already been managing at the time of the bankruptcy filing, often making it the best party to conduct operations during the reorganization.
- The presumption is eliminated if existing management cannot be depended upon to carry out fiduciary responsibilities of a trustee.
    - *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985)
- Under section 1104(a)(1), the appointment of a trustee is mandatory upon a finding of "cause." Bankruptcy Code section 1104(a)(1) identifies four bases upon which "cause" may be found – fraud, dishonesty, incompetence, and gross mismanagement. These enumerated grounds are not exclusive, and additional grounds may be determined on a case-by-case basis.
    - *In re V. Savino Oil*, 99 B.R. 518, 525 (Bankr. E.D.N.Y. 1989)
- Cause also may be established by the (i) materiality of the misconduct of the debtor's management, (ii) evenhandedness or lack of same in dealings with insiders or affiliated entities vis-à-vis other creditors, (iii) existence of prepetition voidable preferences or fraudulent transfers, (iv) unwillingness or inability of management to pursue estate causes

of action, (v) conflicts of interest on the part of management interfering with its ability to fulfill fiduciary duties to the debtor, and (vi) self-dealing by management or waste or squandering of corporate assets.

- *Marvel*, 140 F.3d at 472–73
- *Sharon Steel Corp.*, 871 F.2d at 1228

- Bankruptcy Code section 1104(a)(2) creates a flexible standard that authorizes the Court to appoint a trustee when it is in the best interests of the creditors and the estate to do so.
  - *Sharon Steel Corp.*, 871 F.2d at 1226
  - *In re Cardinal Indus., Inc.*, 109 B.R. 755, 767 (Bankr. S.D. Ohio 1990)
  - *Microwave Prods. of Am., Inc.*, 102 B.R. 666, 675 (Bankr. W.D. Tenn. 1989)
- Courts consider numerous factors when determining whether to appoint a trustee under Bankruptcy Code section 1104(a)(2), including:
  - (i) the trustworthiness of the debtor
    - *In re Evans*, 48 B.R. 46, 48 (Bankr. W.D. Tex. 1985)
  - (ii) the debtor-in-possession's past and present performance and prospects for the debtor's rehabilitation
    - *In re Parker Grande Dev., Inc.*, 64 B.R. 557, 561 (Bankr. S.D. Ind. 1986)
    - *In re L.S. Good & Co.*, 8 B.R. 312, 315 (Bankr. N.D. W. Va. 1980)
  - (iii) the confidence – or lack thereof – of the business community and of creditors in present management
    - *In re Concord Coal Corp.*, 11 B.R. 552, 554 (Bankr. S.D. W. Va. 1981)
  - (iv) the benefits derived by the appointment of a trustee, balanced against the cost of the appointment
    - *Microwave Prods. of Am., Inc.*, 102 B.R. at 675
    - *Sharon Steel Corp.*, 86 B.R. at 466 ("[i]n a case of this magnitude, the cost of having a trustee in place is insignificant when compared with the other costs of administration and when compared with the enormous benefit to

be achieved by the establishment of trust and confidence in . . . management.")

- *Ionosphere Clubs*, 113 B.R. at 168
- *In re Madison Mgmt.*, 137 B.R. 275, 282 (Bankr. N.D. Ill. 1992).

ISSUES RELATED TO THE APPOINTMENT OF A TRUSTEE OVER THE RETENTION OF MANAGEMENT

- Experienced management is generally the most knowledgeable about the business and operations of a debtor and is in the best position to take the necessary actions for a successful reorganization.
- Appointment of a trustee may bring with it the following adverse effects:
  - The manner in which a trustee is selected does not assure that the trustee has skills and experience with the business of the debtor.
  - It is unusual, industry experience aside, that trustee candidates are familiar with the specific circumstances of a debtor's issues and operations. For an operating company, the time and expense of bringing a trustee "up to speed" can be detrimental to the overall process, thereby robbing the debtor of critical time in its reorganization.
  - Trustees typically come with their own entourage. The professional assistance that any debtor requires is usually significant and the appointment of a trustee does not just mean the substitution of one lead individual for another. Trustees generally bring in a new team of professionals with accompanying delays and costs for achieving familiarity with the situation.
- The forced appointment of a trustee may have adverse critical effects on operations.
  - A trustee may not wish to undertake the responsibilities of an operating company and may move to minimize the operations as quickly as possible, thereby minimizing value and the prospects of achieving a successful operating reorganization;
  - Employees critical to the debtor's ability to execute a reorganization may be more inclined to seek safer employment elsewhere due to real or perceived indications of personnel reductions.

- A debtor's chapter 11 financing with a DIP Lender will most likely contain default provisions if there is a change in management and/or if a trustee is appointed. This is a logical provision largely reflecting a lenders concern about the issues outlined above.
- A trustee's appointment imposes additional statutory fees, which can be substantial.

MANAGEMENT ACTIONS TO TAKE WHERE CAUSE MAY EXIST TO APPOINT A TRUSTEE

Since changes to the bankruptcy code in 2005, the Office of the United States Trustee has raised issues in a number of cases seeking the appointment of trustees in situations with allegations of pre-petition improper acts by management. Many of these cases involving alleged or acknowledged improper activity had replaced management prior to the start of the bankruptcy case. Some have also reflected situations where creditors or other parties have used innuendo to cause the US Trustee to raise the issues as the creditors seek leverage over the debtor.

- Despite management changes by a debtor prior to seeking bankruptcy protection, concerns may continue to exist for a closely held enterprise without independent board or managing member oversight.
- In conjunction with the appointment of a Chief Restructuring Officer or other responsible officer, debtors are frequently advised to take one or more of the following actions to assure that an independent fiduciary is permanently in place in circumstances where concerns may be raised regarding the appointment of a trustee:
    - Appoint an independent director or independent directors where the board or member consists solely of shareholders or parties related to shareholders.
    - Amend the by-laws, corporate charter, or operating agreement to irrevocably remove authority from the shareholder(s) to further amend the board, operating committee, restructuring committee, or their responsibilities for the duration of the bankruptcy proceeding or restructuring.

- When a management change is made, a concern voiced by the US Trustee or others seeking the appointment of a trustee is that the change may only be temporary if the board/member structure is left unchanged. In such a situation, the CRO or responsible officer may be viewed as beholden to the insider or incumbent board for the position and thereby lack independence of action from any agenda that may not be in the best interest of the estate.
- If done appropriately and thoroughly, amendment of the articles of corporate governance combined with independent appointment(s) should assuage this issue.
- Establish an independent restructuring committee responsible for all actions related to the restructuring. Independent director or member responsibility for the CRO or operating management's action, particularly where the board may be comprised of incumbent and newly-appointed independent directors provides an additional level of corporate governance separate from the shareholder or related parties.
- Provide clear lines of communication and responsibility to the independent board/member and or restructuring committee in the CRO's engagement arrangements.
- Leaving appropriate new management in place is supported by the legislative history of section 1104 of the Bankruptcy Code.
    - HR Rep. No. 95-595 at 233 (1977)
    - *In re The 1031 Tax Group, LLC*, 374 B.R. 78, 86 (Bankr. S.D.N.Y. 2007)
    - *In re Adelphia Comm. Corp.*, 336 B.R. 621 (Bankr. S.D.N.Y. 2006)
- Key factors that favor an independent board and independent responsible officers rather than a trustee to manage a debtor and carry out the reorganization include the following:
    - Qualifications in the industry, operational experience, and familiarity with the restructuring environment
    - Effective transition and communications within the organization resulting in greater stability

- Avoidance of duplicative costs
- Preservation of time for restructuring

CASE EXAMPLES – TRUSTEE APPOINTED

In re V. Savino Oil & Heating

In *Savino Oil*, creditors obtained a state court judgment to foreclose upon the collateral of V. Savino Oil & Heating Co., Inc. ("Savino I"). *In re V. Savino Oil & Heating*, 99 B.R. at 521. Savino I responded by appealing the state court's decision, but also formed a new legal entity named V. Savino Oil Co., Inc. ("Savino II"). *Id.* at 521–22. As the court explained, a central purpose of the debtor's scheme was to transfer Savino I's assets to Savino II before Savino I filed for bankruptcy, thereby placing them beyond the reach of the Savino I's creditors. *Id.* at 523. The court held that Savino I's prepetition course of conduct constituted "cause" for the appointment of a Chapter 11 trustee. *Id.*

In re Lowenschuss

In *Lowenschuss*, the bankruptcy court appointed a chapter 11 trustee because of the debtor's history of manipulating a pension plan and his control over the pension plan's nominal trustee supported the bankruptcy court's finding that it would be in the best interests of the creditors to have an independent and disinterested trustee to administer the estate and to pursue debtor's unauthorized transfers of property. *In re Lowenschuss*, 171 F.3d 673, 685 (9th Cir. 1999). After ten years of litigation, a Pennsylvania court entered an order for the equitable distribution of the marital property of the debtor and his ex-wife. *Id.* at 676. To evade transferring to his ex-wife her share of the pension plan, the debtor transferred over $8 million in pension plan assets outside Pennsylvania to avoid the jurisdiction of the Pennsylvania courts. *Id.* at 677. The debtor then relocated to Nevada where he filed a chapter 11 petition. *Id.*

The United States Court of Appeals for the Ninth Circuit held that the prepetition transfer of pension plan assets, the debtor's personal flight out of Pennsylvania to Nevada, and his control over the pension plans were good cause to appoint a chapter 11 trustee. *Id.* at 685.

In re Rivermeadows Assocs., Ltd.

In *Rivermeadows*, the court appointed a chapter 11 trustee for cause under Bankruptcy Code section 1104(a)(1) based largely upon the prepetition business practices of the debtor's controlling party, Donald M. Albrecht. *In re Rivermeadows Assocs., Ltd.*, 185 B.R. 615, 617 (Bankr. D. Wyo. 1995). The Court noted three specific areas of concern to justify its appointment of a trustee: (i) Mr. Albrecht's disregard for the judicial process, even at the expense of the debtor, (ii) the unbelievably complicated history of Mr. Albrecht's business

dealings (demonstrating Mr. Albrecht's disregard for the structure and requirements of legal entities and a lack of sound fiduciary practice), and (iii) the inconsistencies in the Debtor's bankruptcy filings. *Id.* at 617–19.

In re Marvel Entm't Group, Inc.

Courts have appointed trustees in circumstances where the conflicts between creditors and the debtor have escalated beyond those conflicts that generally exist to acrimony or lack of cooperation that jeopardizes the reorganization process. *See*, *e.g.*, *Marvel Entm't Group, Inc.*, 140 F.3d at 472–73; *see also In re Nartron Corp.*, 330 B.R. 573, 590–91 (in light of "parties' inability to reach a consensus about anything," the court concluded that there was "no reasonable likelihood of any cooperation between the parties in the near future" and ordered the appointment of a trustee). In *Marvel*, the Third Circuit Court of Appeals upheld the appointment of a trustee due to the "deep-seeded conflict and animosity" between the debtors and its creditors. *Id.* at 473. The Third Circuit Court of Appeals stated, "[t]he intense and high stakes bickering between the [debtor] interests and the Lenders does not instill confidence that the [debtor] interests could fairly negotiate with the creditors to whom they owe [fiduciary] duties, nor that reorganization will occur effectively." *Id.* at 474.

U.S. DEPARTMENT OF JUSTICE
EXECUTIVE OFFICE FOR UNITED STATES TRUSTEES

Excerpt from United States Trustee Manual, Volume 3: Chapter 11 Case Administration

http://www.justice.gov/ust/eo/ust_org/ustp_manual/index.htm

CHAPTER 3-6: APPOINTMENT OF CHAPTER 11 TRUSTEES AND EXAMINERS

3-6.1 GROUNDS FOR APPOINTMENT

3-6.1.1 Statutory Basis: 11 U.S.C. § 1104

Section 1104 sets forth the statutory provisions regarding the appointment of a trustee or examiner. Section 1104(a)(1) requires the court, upon request by the United States Trustee or a party in interest, to order the appointment of a trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause . . . ."

In the alternative, the court can order the appointment of a trustee pursuant to the provisions of section 1104(a)(2). This subsection provides that the court shall order the appointment of a trustee if such an appointment is determined to be in the interests of creditors, any equity security holders, and other interests of the estate.

Finally, the court may order the appointment of a trustee if grounds exist for conversion or dismissal of the case but the court determines that the appointment of a trustee is in the best interests of the creditors and the estate. 11 U.S.C. § 1104(a)(3).

If the court does not order the appointment of a trustee, section 1104(c) permits the court, on request of a party in interest or the United States Trustee, to order the appointment of an examiner. Such an appointment shall be ordered:

1. if it is determined to be in the interests of creditors, any equity security holders, and other interests of the estate; or

2. if the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000.

If the court orders the appointment of a trustee or examiner, the United States Trustee shall, after consultation with parties in interest, select one disinterested person to serve in the position. 11 U.S.C. § 1104(d).

3-6.1.2 Section 1104(e) Considerations

Pursuant to section 1104(e), the U.S. Trustee shall move to appoint a trustee if there are reasonable grounds to believe current company officials participated in actual fraud, dishonesty, or criminal conduct in the "management of the debtor or the debtor's public financial reporting." This provision applies to chapter 11

cases commenced on or after April 20, 2005. It applies to all chapter 11 debtors, not just publicly held companies, and it applies to both pre-petition conduct and post-petition conduct. Note that section 1104(e) only provides for the *filing* of a motion under certain circumstances; it does not change the grounds for granting the motion.

3-6.2 CHOICE OF REMEDY – TRUSTEE OR EXAMINER

Trustees and examiners perform distinct functions. A trustee displaces the debtor in possession and assumes responsibility for estate assets and for the operation of the business. An examiner reviews specific transactions or circumstances as directed by the order authorizing appointment. Accordingly, a determination of whether to request the appointment of a trustee or an examiner will depend on the results desired.

One factor the United States Trustee must take into account is if sufficient admissible evidence is available to establish grounds for the appointment of a trustee. Mere suspicion or allegations of wrongdoing are not sufficient. Admissions by the debtor or its agents in public filings, in schedules and statements of financial affairs, or at the section 341 meeting may be used to support a motion. Discovery is available. Third parties or whistle-blowers might also provide the United States Trustee with evidence.

Questions have arisen over the burden of proof that must be met to establish cause for the appointment of a trustee. Many courts have ruled that a trustee motion must be proven with "clear and convincing" evidence. See, e.g., *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 471 (3rd Cir. 1998). In the absence of controlling circuit authority, United States Trustees should contend that the appropriate burden of proof is "preponderance of the evidence." See *Tradex Corp. v. Morse (In re Tradex Corp.)*, 339 B.R. 823 (D. Mass. 2006). United States Trustees faced with this issue should contact the Office of the General Counsel.

Section 1104(a)(1) enumerates several specific grounds, including fraud, dishonesty, and incompetence, which constitute cause and require the appointment of a trustee. This list of factors constituting cause is not exclusive. See 11 U.S.C. § 102(3). Other situations that may constitute cause include the debtor's violation of a court order or breach of fiduciary duties, failure of the debtor to cooperate with the United States Trustee's efforts to supervise the administration of the case, or internal dissension in the corporate hierarchy resulting in failure to operate properly. See *In re Colorado-Ute Elec. Ass'n, Inc.*, 120 B.R. 164, 175-76 (Bankr. D. Colo. 1990); *In re Sullivan*, 108 B.R. 555, 556 (Bankr. E.D. Pa. 1989); *In re St. Louis Globe-Democrat, Inc.*, 63 B.R. 131, 137-38 (Bankr. E.D. Mo. 1985).

It should be noted that the examples of "cause" included in section 1104(a)(1) all involve "current management." Generally speaking, if management that has engaged in misconduct has been truly displaced by competent and honest management, the appointment of a trustee may not be warranted. The United States Trustee should, however, inquire into the relationships between ousted management and those currently operating the debtor. Former management may retain the right under state law to replace current management if former management controls the equity interests of the debtor. Furthermore, the debtor's board of directors or similar governing body may still be composed of persons on whose watch the misconduct occurred. Under these circumstances, the United States Trustee should consider seeking a trustee appointment.

Under section 1104(a)(2), a trustee may also be appointed if it is in the interest of creditors, equity security holders, and other interests of the estate. The language of the statute provides little guidance on how it is to be applied. It is clear, however, that the court is called upon to weigh the interests of all constituencies in the case, and not just those of creditors. Where the debtor's business affects such a large segment of the general public, consideration of the public interest becomes a greater factor in deciding whether to order the appointment of a trustee under section 1104(a)(2). See *In re Ionosphere Clubs, Inc.*, 113 B.R. 164 (Bankr. S.D.N.Y. 1990). Courts have also considered factors such as the trustworthiness of the debtor, its past and present performance and prospects for rehabilitation, and the confidence, or lack thereof, of the business community and creditors in present management.

The United States Trustee should consider seeking the appointment of an examiner to investigate any questionable management activities or any unexplained irregularity in the debtor's financial history. See *In re Gilman Servs., Inc.*, 46 B.R. 322, 327-28 (Bankr. D. Mass. 1985).

Section 1104(c)(2) requires the court to order the appointment of an examiner if a request for the appointment is made by the United States Trustee or other party in interest, and the debtor's fixed, liquidated, unsecured debts (other than debts for goods, services, taxes, or owing to an insider) exceed $5 million. The appointment of an examiner is mandatory if the dollar threshold is met. See *In re Revco D.S., Inc.*, 898 F.2d 498, 500-01 (6th Cir. 1990). The United States Trustee should not automatically request the appointment of an examiner in every case having the requisite amount of qualifying debt. In deciding whether to seek an examiner appointment, the United States Trustee should carefully consider all relevant factors, including whether pre-petition or post-petition events involving the debtor warrant an independent investigation and report.

Courts occasionally direct the appointment of a mandatory examiner under section 1104(c)(2) but severely constrain the scope of examination. Some courts have directed that an examiner perform no investigation at all. The United

States Trustee should consult with OGC if either of these circumstances occurs or appears to be imminent. Furthermore, a party arguing or court finding that section 1104(c)(2) is not mandatory should immediately be brought to OGC's attention.

The United States Trustee may take a position on another party's motion for the appointment of a trustee or an examiner; the United States Trustee should not, however, file joint pleadings with other parties in interest. Nor should the United States Trustee adopt verbatim the allegations and arguments contained within the pleadings filed by other parties. A separate pleading setting forth the position advocated by the United States Trustee should be filed.

The statutory duties of both chapter 11 trustees and examiners are set out in section 1106. Section 1106(a)(3), which is made applicable to examiners by section 1106(b), requires an investigation into the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan. That subsection also grants the court the authority to restrict the scope of the investigation. Court-imposed limitations on the permissible scope of an examination are most frequently set forth in the same order that authorizes the appointment of the trustee or examiner. The United States Trustee should ensure that any restrictions and limitations contemplated by the court are clearly set forth in the order. This will avoid the delay and expense that would be engendered by having to return to the court for clarification of the original order.

Section 1106(b) also allows for the expansion of an examiner's duties to encompass any other duties of a trustee that the court orders the debtor in possession not to perform. Again, the United States Trustee should ensure that the precise scope of the expanded duties contemplated for the examiner is clearly set forth in the order of appointment.

3-6.3 THE SELECTION PROCESS

The procedures set forth below apply to the United States Trustee's appointment of a chapter 11 trustee or examiner in any chapter 11 case. In summary, in a chapter 11 case, once the court has determined that a trustee or examiner should be appointed, the authority to select and appoint the trustee or examiner is vested in the United States Trustee. 11 U.S.C. § 1104(d); *In re Plaza de Diego Shopping Center, Inc.*, 911 F.2d 820, 829 (1st Cir. 1990).

Section 1104 of the Bankruptcy Code lists four basic conditions that must be satisfied when the United States Trustee appoints a trustee or examiner:

- the United States Trustee must "consul[t] with parties in interest;"
- the person appointed must be "disinterested;"

- the person appointed may not be the United States Trustee; and
- the appointment must be submitted to the Bankruptcy Court for approval.

11 U.S.C. § 1104(d).

In addition, Federal Rule of Bankruptcy Procedure 2007.1 provides that the order approving the appointment must be made on application of the United States Trustee and lists certain information that must be included in that application. The application must also be accompanied by a verified statement by the person appointed listing his or her connections with other parties and participants in the bankruptcy case. Fed. R. Bankr. P. 2007.1(c).

3-6.3.1 Timing

The process of selecting a trustee or examiner should occur as promptly as possible once the court has ordered that a trustee or examiner be appointed. Before making the appointment, the United States Trustee must engage in a meaningful consultative and deliberative process, taking into consideration that in some cases timing of the appointment may be affected by the potential risk to estate assets from undue delay. In some larger and more complex cases, and when expediency may require it, the United States Trustee should begin identifying candidates even before the entry of the order directing the appointment if it is reasonably certain an appointment will be ordered. Although an order directing the appointment of a trustee creates a 30-day window in which any party in interest may request that a creditors' meeting be held to elect a trustee, 11 U.S.C. § 1104(b)(1), the United States Trustee is not required to-and should not-wait before appointing a trustee because of the prospect of an election. See 11 U.S.C. § 1104(b)(2)(B)(ii) (service of trustee appointed under subsection (d) terminates once election of different trustee under subsection (b) is certified). As a result, the United States Trustee should not delay the appointment process even if there is reason to believe that a request for election may be forthcoming.

3-6.3.2 Duty to Consult

The United States Trustee's first step in the selection of a trustee or examiner is to solicit the views of "parties in interest," as section 1104(d) requires. Although the Bankruptcy Code does not specify the parties the United States Trustee should consult, at a minimum, the United States Trustee should confer with the debtor, any official committees, the pre-petition and post-petition lenders, and any key creditors, including governmental authorities, who are expected to play an active role in the chapter 11 case. It is better to be over-inclusive than under-inclusive in the consultation process.

Because the duty to consult is an important statutory duty, the United States

Trustee should never agree to appoint a particular candidate. Rather, during the consultation process parties in interest should be assured that their views and any suggested candidates will be duly considered. Despite the statutory requirement to consult with parties in interest, the decision to make the best appointment for the case ultimately rests within the discretion of the United States Trustee. Indeed, for this reason, it is inappropriate for any court order directing the appointment of a trustee or examiner to specify who should be appointed or to condition the order on the appointment of a particular person.

3-6.3.3 The Consultation Process

There is no required form that the section 1104(d) consultation should take. The United States Trustee should solicit both general input and specific nominations. Parties in interest should be asked to identify any specialized skills, experience, or qualifications that they believe the trustee or examiner should have. Parties should also be encouraged to submit the names and contact information for any individuals they believe would be well qualified to serve. During the consultation process, the United States Trustee should not ask the parties in interest to react to or express an opinion about particular candidates the United States Trustee may be considering for the appointment.

In smaller cases, informal methods of consultation are often preferable. In particular, if counsel for all major constituencies are present when the court directs the appointment of a trustee or examiner, it may be most effective to consult with parties orally in the courtroom immediately after the hearing. In more complex cases, or in cases where there are a large number of parties to consult, the United States Trustee may send a letter soliciting input from parties in interest.

3-6.3.4 Consideration of Additional Candidates and Consultation with Other United States Trustees

The United States Trustee is obligated to appoint the most qualified individual to serve in the particular case. Therefore, although the nominations of parties in interest are an important resource for identifying candidates, the United States Trustee has discretion to and should consider candidates from other sources as well.

In certain cases, one source for additional trustee candidates may be the local panel of chapter 7 trustees. Appointing a panel trustee, however, should not be the automatic or default choice, even if the case is not complex or involves a liquidation. Moreover, the determination that a panel trustee is appropriate for appointment as trustee in a particular case does not eliminate the United States Trustee's statutory duty to consult with parties in interest. During the consultation process, the United States Trustee should never take or voice the

position that the choice of candidates is limited solely to panel trustees.

The Executive Office for United States Trustees also maintains a directory of trustee and examiner candidates. The trustee and examiner portal is a resource that United States Trustees can use to both identify other skilled, qualified candidates beyond local panel trustees and the bar and to determine whether potential candidates have been vetted by other United States Trustees. The searchable résumé database contains information on candidates in a variety of fields and geographic locations. It is not, and should not be viewed as, the sole source of information to consider, and it is not a list of approved candidates. However, you should consult the portal any time you have an appointment, and if your candidate is included in the portal, it is imperative that you consult with the United States Trustee who either appointed or considered that candidate in other cases to determine whether the candidate is appropriate for the appointment you must make.

3-6.3.5 Eligibility and Disinterestedness

Although section 321 of the Bankruptcy Code arguably permits appointment of corporations and firms as well as individual persons to serve as trustee or examiner, the USTP's policy is to appoint individuals only and to avoid the appointment of professional firms or corporations. In addition, the Bankruptcy Code prohibits the United States Trustee from appointing multiple persons to serve as co-trustees or co-examiners. See 11 U.S.C. § 1104(d) (appoint "one disinterested person"). Anyone that has previously served as an examiner may not thereafter serve as a trustee in the same case. See 11 U.S.C. § 321(b). Unlike cases arising under chapters 7, 12, and 13, there is no statutory geographic limitation on who may be appointed as a chapter 11 trustee. See 11 U.S.C. § 321(a).

Under section 1104(d), the trustee or examiner must be a "disinterested person," as that term is defined in section 101(14) of the Bankruptcy Code. The test is the same one that applies to the debtor's professionals. That test disqualifies from service, among other persons, creditors, equity holders, former directors and officers (within the past two years), and persons in control, as well as any person who is directly or indirectly "materially adverse" to the debtor for any reason. See 11 U.S.C. §§ 101(14)(A), (B), (C) and 101(31)(B).

In some cases, parties may request that the United States Trustee appoint as trustee a person who has already been appointed as the receiver of the debtor in another proceeding. Any receiver, whether sought by a creditor or governmental entity such as the SEC, is a "custodian." See 11 U.S.C. § 101(11). Section 543 provides that, unless the court directs otherwise, any custodian holding the debtor's property must turn over that property to the debtor-in-possession or chapter 11 trustee. 11 U.S.C. § 543. In many cases, these receivers cannot be

appointed as trustee because they do not meet the disinterestedness test of the Bankruptcy Code, either because they are currently acting as an officer of the debtor or are otherwise "in control" of the debtor, or because their fiduciary duties as receiver could conflict with their duties as trustee or examiner. While there is no per se rule disqualifying receivers from consideration as trustee or examiner, nominations of current or past receivers should be scrutinized carefully for conflicts issues. Before appointing any receiver as trustee, the United States Trustee should consult with OGC.

3-6.3.6 The Selection

Once a pool of qualified candidates has been identified, the United States Trustee should act quickly to contact each of the candidates to confirm their interest in serving, immediately identify any obvious disqualifying conflicts and instruct them to commence their preliminary conflict checks, and otherwise determine their eligibility and suitability to serve. The United States Trustee should request from each candidate a recent and detailed curriculum vitae.

The United States Trustee, or her staff in appropriate cases, should interview the candidates who appear most qualified to serve, including those candidates with whom the United States Trustee is already familiar, to determine their suitability for appointment in the particular case. While the law requires consultation with the parties in interest, it does not require the United States Trustee to interview every recommended candidate, although this may be preferable in cases in which the number of candidates is few. The candidate ultimately chosen for appointment must be interviewed. Whether to conduct interviews in person or by telephone or video teleconference may be dictated by the exigencies of the case.

All appointees must conduct conflicts checks and complete and submit to the United States Trustee affidavits regarding their background, connections, and conflicts. These affidavits consist of: (1) the candidate's verified statement of connections pursuant to Rule 2007.1; and (2) a chapter 11 security affidavit.

The verified statement must "set[] forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." Fed. R. Bankr. P. 2007.1(c). A verified statement is required even if the candidate is a panel or case trustee. The format and content of the verified statement should be identical to that of a Rule 2014 statement of a professional retained under 11 U.S.C. § 327. The candidate must also provide to the United States Trustee a chapter 11 security affidavit.

In addition, the United States Trustee should ask the selected trustee or examiner to make periodic informal reports to the United States Trustee in appropriate

cases.

3-6.4 THE NOTICE OF AND APPLICATION TO APPROVE APPOINTMENT

3-6.4.1 Notice of Appointment

The appointment should not be made until the United States Trustee has received and reviewed the Rule 2007.1 verified statement and chapter 11 affidavit and confirms the candidate's eligibility and disinterestedness. Upon making a selection, the United States Trustee must serve a notice of appointment on the trustee or examiner.

3-6.4.2 Application to Approve Appointment

After making the appointment, the United States Trustee should immediately file with the court an application to approve the appointment. Fed. R. Bankr. P. 2007.1(c). The application should set forth the following information: (1) the name of the trustee or examiner; (2) a list of all parties in interest with whom the United States Trustee consulted; and (3) a statement that, to the best of the United States Trustee's knowledge, the proposed trustee or examiner is disinterested.

The application typically includes three documents: the United States Trustee's notice of appointment, the trustee or examiner's Rule 2007.1 verified statement, and a proposed order.

1. Notice of appointment

   The notice of appointment is served on the trustee or examiner and is filed with the court as an exhibit to the application. If a trustee will be required to post a case-specific bond, see infra Section 3-6.4.4.2, the notice should also state the amount of the bond. Fed. R. Bankr. P. 2008.

2. Verified statement

   The application must be accompanied by the appointee's verified statement "setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee." Fed. R. Bankr. P. 2007.1(c). See supra section 3-6.3.6.

3. Order

   The order approving the appointment is typically limited to a statement that the United States Trustee's application is granted. It is not necessary

for this order to incorporate any substantive terms from the order directing appointment.

3-6.4.3 Security Clearance

In addition, all persons appointed as chapter 11 trustees or examiners must undergo a security clearance. Full background checks are not required for any individual for whom a background investigation is already in progress or has been completed within the preceding five years in connection with another examiner or trustee appointment. The United States Trustee should contact the Office of Oversight in EOUST upon identifying a candidate for trustee or examiner in order to determine if the candidate has a full background check already on file. If a security clearance is required, the candidate must complete and submit to the United States Trustee a standard packet of background investigation forms. The United States Trustee should monitor the trustee or examiner to ensure that these forms are timely completed and, upon receipt and review, should forward the completed forms to the Office of Oversight in EOUST.

3-6.4.4 Acceptance of Appointment and Posting of Bond

3-6.4.4.1 Acceptance of Appointment

Under Federal Rule of Bankruptcy Procedure 2008, within seven days of the receipt of the notice of appointment, a trustee must provide written notice of acceptance to both the court and the United States Trustee. Fed. R. Bankr. P. 2008. A chapter 11 trustee who fails to provide such notice is deemed to reject the appointment. This is a critical distinction from trustee appointments in most cases under chapters 7, 12, and 13, where the failure to file a rejection (in most circumstances) is deemed acceptance of the trustee appointment. The letter transmitting the notice of appointment to the trustee might include a reminder of this requirement and instructions of how to return the written acceptance. Rule 2008 does not apply to examiners.

3-6.4.4.2 Posting of Bond

To qualify as a chapter 11 trustee, the trustee must post a bond in favor of the United States of America and file it with the court no later than six days ("before seven days") after selection. 11 U.S.C. § 322(a). The United States Trustee must determine both the initial amount and sufficiency of the bond. 11 U.S.C. § 322(b)(2). The United States Trustee should evaluate the assets of the estate when initially setting the amount of the bond. The bond should be set at a level sufficient to ensure the confidence of the parties, while considering that the estate will bear the cost of the bond premium. See United States Trustee Program Policies and Practices Manual § 7-2.2.4 (Chapter 11 Trustees and

Examiners). Thereafter, the chapter 11 trustee must monitor the amount of funds on hand and ensure that the bond is maintained in an adequate amount, generally at least one and one-half times (150%) of the average monthly balance of funds on hand.

The surety on any bond written in favor of the United States of America must be authorized by the Secretary of the Treasury. 31 U.S.C. §§ 9304 and 9308. The Treasury Department publishes Treasury Circular 570, a list of companies holding certificates of authority as acceptable sureties on federal bonds, every July 1 in the Federal Register. The Circular is also posted on the Internet, available at http://www.fiscal.treasury.gov/fsreports/surety/c570.htm. The United States Trustee may only approve those companies appearing on this list as sureties on trustee bonds, and should consult the Circular before approving any trustee bond to ensure coverage falls within authorized underwriting limits, which are on a per-bond basis. If a bond exceeds authorized underwriting limits, it cannot be approved absent proper coinsurance or reinsurance. See United States Trustee Program Policies and Practices Manual § 7-2.1.2 (Sufficiency of the Surety).

An examiner ordinarily need not obtain a bond. But if the examiner is given expanded powers despite the United States Trustee's objection and has access to assets of the estate, the United States Trustee should request that a bond be posted. Id. at § 7-2.2.4 (Chapter 11 Trustees and Examiners).

This discussion is intended as a summary and is not exhaustive. United States Trustees should consult Volume 7 of the United States Trustee Program Policies and Practices Manual for additional information and guidance regarding bonding requirements and procedures governing fiduciaries of estate assets.

3-6.5 TERMINATION OF A TRUSTEE'S APPOINTMENT

Under 11 U.S.C. § 1105, the court, on request of the United States Trustee or a party in interest and after notice and a hearing, may terminate the trustee's appointment and restore the debtor to possession. Section 1105 is intended to address instances in which the debtor's situation has changed and the need for a trustee no longer exist. The removal of the trustee may reflect a change in the circumstances under which the appointment was made. See *In re Eastern Consol. Utils., Inc.*, 3 B.R. 591, 592-93 (Bankr. E.D. Pa. 1980). While the result of this order would place the debtor in possession back in control of the operation of the business, the court may nevertheless order the operation of the business to cease under 11 U.S.C. § 1108.

3-6.6 REMOVAL OF A TRUSTEE OR EXAMINER

Pursuant to 11 U.S.C. § 324(a) the court may, for cause, remove a trustee or an

examiner. Notice and a hearing regarding the matter must be provided as required by section 102(1).

The Bankruptcy Code does not list specific grounds constituting cause for removal. Determining whether circumstances warrant the removal of a trustee or examiner is necessarily left to the court on a case-by-case basis. Many of the reported decisions on the application of section 324 arise in the context of chapter 7 cases. As with chapter 7 trustees, the United States Trustee must ensure that chapter 11 trustees and examiners are appropriately supervised and held accountable for their actions. To the extent that these individuals are not filing reports or otherwise complying with their fiduciary obligations, a motion seeking their removal should be filed. Unless the court orders otherwise, the removal of a trustee or an examiner in any one bankruptcy case effects the trustee's or examiner's removal in all other cases in which the trustee or examiner is then serving. 11 U.S.C. § 324(b).

In the event of an allegation of loss of estate funds held by the chapter 11 trustee, the United States Trustee should follow guidance set forth in Manual Volume 2, on chapter 7 case administration.

A trustee who has been removed must still file a final report and account of the administration of the estate. See 11 U.S.C. § 704(a)(9) made applicable to chapter 11 trustees by 11 U.S.C. § 1106(a)(1). The removed trustee must also turn over all books, records, and other assets of the estate to a successor trustee, and indeed can be compelled to do so if necessary. See 11 U.S.C. § 542(a); *In re Grand Jury Proceedings*, 119 B.R. 945, 952-55 (E.D. Mich. 1990); *Matter of Jim's Garage*, 118 B.R. 949, 951-53 (Bankr. E.D. Mich. 1989). The successor trustee appointed in any such case must also file an accounting of the prior administration of the estate. Fed. R. Bankr. P. 2012(b)(2).

3-6.7 ELECTION OF A TRUSTEE

Section 1104 allows creditors to elect a trustee in chapter 11 cases. Pursuant to section 1104(b)(1), the election of the chapter 11 trustee is to be conducted in the same manner as the election of a chapter 7 trustee**.** See Fed. R. Bankr. P. 2007.1 for procedures for the election of a chapter 11 trustee.

3-6.7.1 Requests for Election

Any party in interest may request the election of a trustee after the court orders the appointment of a trustee under section 1104(a). The request must be made no later than 30 days after the court orders the appointment. See 11 U.S.C. § 1104(b)(1) and Fed. R. Bankr. P. 2007.1(b)(1).

If a timely request for election is made, the United States Trustee must convene a section 341 meeting. See 11 U.S.C. § 1104(b)(1). In the event that the section 341 meeting initially convened in the case has been concluded, section 1104(b)(1) and Rule 2003(f) (Special Meetings) provide authority for the United States Trustee to convene another meeting of creditors for the purpose of holding a trustee election. Notice should be given in the same manner as for any section 341 meeting. See Fed. R. Bankr. P. 2002(a)(1) and 2007.1(b)(2). Parties should be able to request the court to shorten the normal 21-day notice period. See Fed. R. Bankr. P. 9006(c)(1).

There appears to be a conflict in the statute regarding the determination of the number of creditors required to request an election. The first sentence of section 1104(b) indicates that an election shall be held "on the request of a party in interest." This would seem to indicate an election should be held even if only one eligible creditor requests the election. However, the second sentence of section 1104(b) further states, "the election of a trustee shall be conducted in the manner provided in subsections (a), (b), and (c) of section 702 of this title." 11 U.S.C. § 702(b) provides that:

> [C]reditors may elect one person to serve as trustee in the case if election of a trustee is requested by creditors that may vote under subsection (a) of this section, and that hold at least 20 percent in amount of the claims specified in subsection (a)(1) of this section that are held by creditors that may vote under subsection (a) of this section.

Id.

As the language of section 1104(b) specifically refers to section 702(b), it would appear that Congress intended that eligible voters holding at least 20 percent in the amount of claims must request the election at the meeting convened upon the request of a party in interest. Therefore, although any single party in interest may request the United States Trustee to convene a meeting of creditors for the purpose of electing a trustee, the 20 percent "requesting" requirement of section 702(b) must also be met before the election may proceed. This interpretation comports with the policy underlying the enactment of section 702(b), namely, "to insure that a trustee is elected only in cases in which there is true creditor interest, and to discourage election of a trustee by attorneys for creditors." H.R. Rep. No. 595, 95th Cong., 1st Sess. 102 (1977).

In chapter 11 cases, as in chapter 7 cases, the right to vote is determined pursuant to Fed. R. Bankr. P. 2003(b)(3). See Fed. R. Bankr. P. 2007.1(b)(2). Rule 2003(b)(3) provides that an unsecured creditor is only entitled to vote if, at or before the meeting, the creditor has filed a proof of claim or a writing setting forth facts evidencing a right to vote. An objection may be made to the claim at the election. If an objection is made to the amount or allowability of a claim for

the purposes of voting, the United States Trustee shall tabulate the votes for each alternative presented by the dispute, and if resolution of such dispute is necessary to determine the result of the election, the tabulations for each alternative shall be reported to the court. See Fed. R. Bankr. P. 2003(b)(3).

A claim or interest is deemed allowed unless a party in interest objects. 11 U.S.C. § 502(a). A proof of claim executed and filed in accordance with the Bankruptcy Rules constitutes *prima facie* evidence of the amount and validity of the claim. See Fed. R. Bankr. P. 3001(f). Accordingly, most courts have concluded that a claim that is *prima facie* valid may not be denied the right to vote because of a mere general assertion that the claim is invalid. See, e.g., *In re Poage*, 92 B.R. 659, 664 (Bankr. N.D. Tex. 1988). The party objecting to the claim for voting purposes must go forward with the evidence to establish the invalidity of the claim. See *In re Metro Shippers, Inc.*, 63 B.R. 593, 599 (Bankr. E.D. Pa. 1986).

Unlike in chapter 7, a creditor in chapter 11 does not need to file a proof of claim unless the claim is disputed, contingent, or unliquidated. See Fed. R. Bankr. P. 3003(c)(2). The schedules constitute *prima facie* evidence of the validity and the amount of the claim. See Fed. R. Bankr. P. 3003(b)(1). Accordingly, an eligible unsecured creditor who holds a claim that is not disputed, contingent, or unliquidated should be deemed to have the right to vote.

The first step in determining whether a sufficient number of creditors has made a request for an election is to determine the proper "claims base" against which the 20 percent "requesting" requirement may be measured. The proper time to compute this universe of voting creditors is as of the time of an election. *In re Williams*, 277 B.R. 114, 117 (Bankr. C.D. Cal. 2002). From a review of Schedule F and filed proofs of claim, the total claims universe eligible to vote in the election should be calculated. This process, which reduces the total universe of claims asserted in the case, may involve:

1. eliminating all Schedule F claims that are superseded by filed proofs of claim;

2. eliminating all Schedule F claims listed in "unknown" amounts;

3. eliminating all Schedule F claims listed as "contingent," "unliquidated" or "disputed";

4. eliminating all filed claims that are superseded by duplicate or amended proofs of claim;

5. eliminating all claims (or portions thereof) filed as "secured" or "priority";

6. eliminating all filed claims listed as "contingent," "unliquidated" or "disputed";

7. eliminating all filed claims that have been paid and satisfied under bankruptcy court orders;

8. eliminating all filed claims as to which objections have been filed or made otherwise; and

9. eliminating all claims filed after the court-ordered bar date. See *In re American Eagle Mfg., Inc.*, 231 B.R. 320, 329-331 (Bankr. 9th Cir. 1999).

3-6.7.2 Election Procedures

The United States Trustee convenes and presides at the election. See 11 U.S.C. § 1104(b)(1) and Fed. R. Bankr. P. 2007.1(b)(2). The meeting should be recorded, as is done with the section 341 meeting. See Fed. R. Bankr. P. 2003(c). The following information should be obtained and recorded:

1. the case name and number;

2. the date of the meeting;

3. the names of all parties in attendance;

4. the name of the individual requesting the election and the claim represented, including the amount of the claim;

5. the name of the claimant requesting an election, a copy of the claim, and a copy of any proxy or power of attorney; and

6. if an attorney is voting a claim, a statement from the attorney that the claimant is a regular client of that attorney or a solicitation statement from the attorney.

If an eligible disinterested trustee is elected, the United States Trustee must file a report certifying that election. See 11 U.S.C. § 1104(b)(2)(A). Furthermore, upon completion of an undisputed election, the United States Trustee shall promptly file with the court a report of the election, including the name and address of any person elected as trustee and a statement that the election is undisputed. See Fed. R. Bankr. P. 2007.1(b)(3)(A). If creditors elect a trustee under section 1104(b)(1), the report filed by the United States Trustee effectively serves as the selection and appointment of such person by the United States Trustee under section 1104(d), and the service of the original chapter 11 trustee

appointed by the United States Trustee terminates. See 11 U.S.C. § 1104(b)(2)(B).

If it is necessary to resolve a dispute regarding the election:

The United States Trustee shall promptly file a report stating that the election is disputed, informing the court of the nature of the dispute, and listing the name and address of any candidate elected under any alternative presented by the dispute. The report shall be accompanied by a verified statement by each candidate elected under each alternative presented by the dispute, setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys, the United States Trustee, and any person employed in the office of the United States Trustee.

Fed. R. Bankr. P. 2007.1(b)(3)(B).

The United States Trustee must deliver a copy of the report and each verified statement to all parties in interest who either have made a request to convene a meeting under section 1104(b), or requested a copy of the report. *Id.* All committees appointed under section 1102 also are to be served with the report and verified statement. *Id.*

A motion to resolve the dispute must be filed within 14 days after the date the United States Trustee files the report. *Id.* If such a motion is not filed within the 14-day period, the person appointed by the United States Trustee in accordance with section 1104(d) and approved in accordance with Fed. R. Bankr. P. 2007.1(c) shall serve as trustee. *Id.* If a motion to resolve the dispute is filed within the 14-day period, the court must resolve the dispute. See 11 U.S.C. § 1104(b)(2)(C). Rule 2007.1 does not provide procedures for judicial resolution of a disputed election in a chapter 11 case. See Fed. R. Bankr. P. 2001.1. However, the procedures applicable in disputed chapter 7 elections may be used as guidance. See Fed. R. Bankr. P. 2003(d)(2). To avoid a gap in service, pending disposition by the court of the disputed election, the interim trustee shall continue in office. See Fed. R. Bankr. P. 2007.1(b)(1).

3-6.7.3 Eligible Voters

Eligible voters are those unsecured creditors who have allowable, undisputed, fixed, liquidated claims that would be entitled to distribution under 11 U.S.C. § 726(a)(2), 726(a)(3), 726(a)(4), 752(a), 766(h), or 766(i). See 11 U.S.C. §§ 702(a)(1) and 1104(b)(1). Given that these provisions of chapter 7 are not applicable in chapter 11 cases, some confusion regarding this portion of section 702(a)(1) may arise. It would appear that Congress intends to allow unsecured, non-priority creditors to be eligible to vote.

Priority unsecured creditors and secured creditors clearly are not eligible to vote. See *In re Aspen Marine Group, Inc.*, 189 B.R. 859, 863 (Bankr. S.D. Fla. 1995); *In re USA Capital, LLC*, 251 B.R. 883, 889-90 (Bankr. D. Colo. 2000). An undersecured creditor should be allowed to vote the unsecured portion of its claim. See 7 *Collier on Bankruptcy*, ¶ 1104.02[8][b][iv], at 1104-29 (16th ed. 2009); *In re Tartan Constr. Co.*, 4. B.R. 655, 658 (Bankr. D. Neb. 1980); but see *In re Lindell Drop Forge Co.*, 111 B.R. 137 (Bankr. W.D. Mich. 1990).

An unsecured creditor with an interest materially adverse to the interests of other unsecured creditors may not vote in a trustee election. 11 U.S.C. § 702(a)(2). For example, an unsecured creditor has a material adverse interest when facts indicate that the creditor has received a voidable preferential transfer. See *In re Lang Cartage Corp.*, 20 B.R. 534, 536 (Bankr. E.D. Wis. 1982). However, the suspicion of an avoidable preference is insufficient to prohibit a creditor from voting. See *In re Poage*, 92 B.R. 659, 665 (Bankr. N.D. Tex. 1988).

However, a creditor with a small equity position is not automatically excluded from voting solely because of the equity interest. 11 U.S.C. § 702(a)(2). The equity interest may be disregarded if it is *de minimus* when compared with the unsecured claim. See H.R. Rep. No. 595, 95th Cong., 2d Sess. 378 (1977). A creditor who is an insider of the debtor is not eligible to vote. See 11 U.S.C. § 702(a)(3).

3-6.7.4 Determining Election Results

The election is void unless creditors holding at least 20 percent in the amount of eligible claims actually vote. 11 U.S.C. § 702(c)(1). The successful candidate must receive votes from creditors holding a majority in the amount of claims that are held by creditors actually voting. 11 U.S.C. § 702(c)(2). The number of creditors voting for or against a candidate is irrelevant, as only the dollar amount of the claim is counted for voting purposes.

The 20 percent "requesting" requirement of section 702(b) is independent of the 20 percent "quorum" requirement of section 702(c)(1). See *In re Oxborrow*, 913 F.2d 751, 753-54 (9th Cir. 1990). At least 20 percent of eligible creditors must request an election regardless of the number of creditors who actually cast votes at an election. *Id.*

3-6.7.5 Solicitation of Proxies

In most cases, not all creditors who wish to vote for a trustee will be in attendance. It is likely that in cases with a significant number of creditors the election will be requested by one or more creditors holding proxies. A proxy is defined in Fed. R. Bankr. P. 2006(b)(1) as a "written power of attorney authorizing any entity to vote the claim or otherwise act as the owner's attorney

in fact in connection with the administration of the estate." The validity of a proxy is determined under Fed. R. Bankr. P. 9010(c).

Proxy holders who have solicited proxies for voting at the election of a trustee must follow the rules set forth in Fed. R. Bankr. P. 2006. The court may reject any proxies, on motion of a party in interest or on its own motion, if there has been a failure to comply with this rule. Fed. R. Bankr. P. 2006 applies in chapter 11 trustee elections. See Fed. R. Bankr. P. 2007.1(b)(2).

The strict rules regulating the solicitation of proxies must be enforced to ensure that a trustee is elected only in cases where there is true creditor interest. The Advisory Committee Note to Fed. R. Bankr. P. 2006 states:

> Creditor control was a basic feature of the Act and is continued, in part, by the Code. Creditor democracy is perverted and the congressional objective frustrated, however, if control of administration falls into the hands of persons whose principal interest is not in what the estate can be made to yield to the unsecured creditors but in what it can yield to those involved in its administration or in other ulterior objectives.

Id.

Any communication concerning a proxy for electing a trustee is deemed solicitation unless the communication is between a creditor and an attorney acting for the creditor. Fed. R. Bankr. P. 2006(b)(2). A communication between an attorney and his/her regular client would not be a solicitation. *Id.*

The requirements for an authorized solicitation are set forth in Fed. R. Bankr. P. 2006(c). The solicitation must be in writing. Fed. R. Bankr. P. 2006(c)(2).

A proxy may be solicited only by the following individuals or committees:

> (A) a creditor owning an allowable unsecured claim against the estate on the date of the filing of the petition; (B) a committee elected pursuant to § 705 of the Code [which does not apply in chapter 11 cases]; © a committee of creditors selected by a majority in number and amount of claims of creditors (i) whose claims are not contingent or unliquidated, (ii) who are not disqualified from voting under § 702(a) of the Code, and (iii) who were present or represented at a meeting of which all creditors having claims of over $500 or the 100 creditors having the largest claims had at least five days notice in writing and of which meeting written minutes were kept and are available reporting the names of the creditors present or represented and voting and the amounts of their claims; or (D) a bona fide trade or credit association, but such association may solicit only creditors

> who were its members or subscribers in good standing and had allowable unsecured claims on the date of the filing of the petition.

Fed. R. Bankr. P. 2006(c)(1).

A committee of unsecured creditors appointed under section 1102 is also entitled to solicit a proxy for the purposes of the election of a chapter 11 trustee. See Fed. R. Bankr. P. 2007.1(b)(2).

The purpose of these restrictions is to protect creditors from the loss of control of the administration of the case to holders of proxies having interests different from the general unsecured creditors. This rule restricts solicitation to those who were creditors at the commencement of the case. Advisory Committee Note, Rule 2006(c).

Fed. R. Bankr. P. 2006(d) expressly prohibits solicitation by five types of persons. First, any entity holding any interest other than that of a general creditor is prohibited from soliciting proxies. Under this provision, secured and priority creditors and the debtor are prohibited from solicitation. Solicitations are prohibited by or on behalf of any custodian. Further, the interim trustee appointed under section 701 is prohibited from soliciting proxies. (Of course, this prohibition is not applicable in a chapter 11 case.) Under that same subdivision, any entity not entitled to vote under section 702 is prohibited from solicitation. Solicitation is not permitted by or on behalf of a transferee of a claim for collection only.

In addition, the solicitation of proxies is not permitted by or on behalf of an attorney at law. Fed. R. Bankr. P. 2006(d). This rule does not regulate communications between an attorney and his or her regular client. Fed. R. Bankr. P. 2006(b)(2). Any other communication between an attorney and any other person or group requesting a proxy from a creditor, however, is a regulated solicitation.

The case of *In re Darland Co.*, 184 F. Supp. 760 (S.D. Iowa 1960), is cited in the Advisory Committee Note to Fed. R. Bankr. P. 2006. In that case, the district court stated that the solicitation of a proxy by an attorney from a creditor who was not a client may be objectionable as unethical conduct. *Id.* at 763-64. The Advisory Committee Note further states that solicitation by an attorney "carries a substantial risk that administration will fall into the hands of those whose interest is in obtaining fees from the estate rather than securing dividends for creditors."

Several bankruptcy courts have refused to recognize proxies that were solicited by attorneys at law. See, e.g., *In re Oxborrow*, 104 B.R. 356, 362 (E.D. Wash. 1989), *aff'd*, 913 F.2d 751 (9th Cir. 1990). These courts recognize that the drafters of the Bankruptcy Rules made a conscious and deliberate decision to

prohibit solicitation by attorneys. But see *In re Diva Jewelry Design, Inc.*, 367 B.R. 463, 475-76 (Bankr. S.D.N.Y. 2007) (attorney is not barred from assisting the solicitation efforts of a creditor or committee, provided it is clear that the attorney, in his or her personal capacity, is not the solicitor and that the solicitation is not on behalf of the attorney in that capacity).

A solicitation statement must be filed with the court and served upon the United States Trustee by a holder of two or more proxies prior to the time voting commences at any meeting of creditors. Fed. R. Bankr. P. 2006(e). Delivering the proxy statement to the presiding official at the meeting is not the equivalent of filing the statement with the clerk of the court. See *In re Brent Indus., Inc.*, 96 B.R. 193, 196 (Bankr. D. Iowa 1989). The solicitation statement must include the following:

1. a copy of the solicitation;

2. identification of the solicitor, the forwarder, . . . and the proxy holder. . . . If the solicitor, forwarder, or proxy holder is an association, there shall also be included a statement that the creditors whose claims have been solicited . . . were members in good standing and had allowable unsecured claims . . . ;

3. a statement that no consideration has been paid or promised by the proxy holder for the proxy;

4. a statement as to whether there is any agreement . . . for the payment of any consideration in connection with voting the proxy, or for the sharing of compensation with any entity, other than a member or regular associate of the proxy holder's law firm, which may be allowed the trustee . . . ;

5. if the proxy was solicited by an entity other than the proxy holder . . . . a statement signed and verified by the solicitor or forwarder that no consideration has been paid or promised . . . ;

6. if the solicitor, forwarder, or proxy holder is a committee, a statement signed and verified by each member as to the amount and source of any consideration paid or to be paid

. . . .

Fed. R. Bankr. P. 2006(e).

3-6.7.6 Qualifications of an Elected Trustee

An elected trustee must be "disinterested." 11 U.S.C. § 1104(b). In addition, the elected trustee must meet the qualifications of section 321. The person elected

to be trustee must be competent to perform the duties. 11 U.S.C. § 321(a)(1). If the elected trustee is a corporation, the corporation must be authorized by the corporation's bylaws or charter to act as a trustee. 11 U.S.C. § 321(a)(2). Additionally, the person cannot have served as an examiner in the case. 11 U.S.C. § 321(b). The elected trustee must post a bond in favor of the United States. 11 U.S.C. § 322(a). The amount of the bond and sufficiency of the surety shall be determined by the United States Trustee. 11 U.S.C. § 322(b)(2).

If the elected trustee has provided no indication of his or her ability or intent to comply with the Bankruptcy Code and Rules and to adhere to fiduciary standards, the court may refuse to certify the election. See *In re Shubov*, 187 F.3d 648 (9th Cir. 1999) (upholding bankruptcy court's rejection of elected chapter 7 trustee, where individual elected lacked experience in chapter 7 cases, the estate was small relative to the resources needed to educate the individual, and the individual lacked financial resources and demonstrated financial irresponsibility).

CHAPTER 3-7: EMPLOYMENT OF PROFESSIONALS

3-7.1 STATUTORY FRAMEWORK: 11 U.S.C. § 327 and FED. R. BANKR. P. 2014

Sections 327, 1103, and 1107 govern the employment of professionals in connection with a chapter 11 case. For professionals employed by creditors' committees pursuant to section 1103, see Manual 3-4.2. The following discussion is primarily directed at the employment of professionals by debtors in possession and chapter 11 trustees. Unless the professional comes within the limited exception provided for by section 327(b), prior court approval of the employment of a professional person is necessary.

The retention process is designed to ensure public confidence in the bankruptcy system, prevent abuses, and achieve some degree of economy in the administration of the case by limiting the retention of professionals to only those instances where it can be demonstrated that the services are necessary. Furthermore, the requirements of section 327 "serve the important policy of ensuring that all professionals appointed pursuant to [the section] tender undivided loyalty and provide untainted advice and assistance in furtherance of their fiduciary responsibilities." *Rome v. Braunstein*, 19 F.3d 54, 58 (1st Cir. 1994). 28 U.S.C. § 586(a)(3)(I) specifically requires the United States Trustee to monitor employment applications and, when appropriate, to file with the court comments with respect to the approval of such applications.

Court approval of a professional person's employment is contingent upon a finding that the applicant has met a two-pronged test:

1. the professional must be disinterested, pursuant to section 327(a); and

2. the professional must not hold or represent an interest adverse to the estate.

The question of whether a professional meets the standards of the law is one for the court to adjudicate after a full disclosure of the facts. A failure to disclose constitutes an independent basis for disqualification.

A professional's conflict of interest may render him or her ineligible to serve as a professional under section 327(a). Despite the requirements of that section and the definition of a "disinterested person" that appears in section 101(14), a professional is not necessarily disqualified from employment because of representation of both the trustee and a creditor. Section 327(c) requires the presence of an actual conflict of interest; however, the statute does not define an actual conflict of interest. Whether the professional's representation is precluded is dependent on a detailed consideration of the relevant circumstances. Few *per se* rules exist in this area, but case law can provide some guidance regarding specific situations.

Some courts require an actual conflict of interest to render counsel not disinterested. Other courts find a potential conflict is disabling. Some courts find that there is no distinction between a potential or an actual conflict. Generally, a finding of actual conflict warrants disqualification of a professional under section 327(a). In addition, under the appropriate circumstance, the appearance of impropriety or an appearance of potential conflict can be grounds for disqualification of counsel.

Pursuant to section 328(c), the court may deny allowance of compensation for services and reimbursement of expenses to a professional employed pursuant to section §§ 327 or 1103 if the court finds that at any time during the employment the professional was not a disinterested person or held or represented an interest adverse to the estate.

The United States Trustee should promptly examine the application for employment and its accompanying verified statement not only to determine if the proposed professional service is necessary, but also to ascertain if any disclosures suggest questionable relationships, divided loyalties, or disqualifying adverse interests. Issues that may warrant closer scrutiny include multiple debtor representation, simultaneous representation of a limited partnership and a general partner, representation of a corporation and an affiliate or shareholder, receipt of a preference or unpaid fees, security interests taken to secure the payment of fees or other unusual arrangements for compensation, and prior or concurrent representation of a major creditor. Where appropriate, the United States Trustee should require further disclosure or comment on any unusual aspects of the

application. The United States Trustee should object to the employment when the services are unnecessary or duplicative, the applicant is not disinterested, or representation of adverse interests warrants disqualification.

Bankruptcy Rule 6003(a) provides that applications to employ professionals cannot be granted within 21 days of the filing of the petition, except to the extent that relief is necessary to avoid immediate and irreparable harm. The United States Trustee should object when relief is sought contrary to Rule 6003(a).

Fed. R. Bankr. P. 2014(a) requires that a copy of the employment application be transmitted to the United States Trustee, but it does not specify any additional parties that must be served. The issue of notice may be addressed by local rule or customary practice. When appropriate, however, the United States Trustee may suggest that only interim orders authorizing employment be entered *ex parte* pending notice and opportunity for objection by parties in interest before the order is permitted to become final.

The contents of an employment application are dictated by Fed. R. Bankr. P. 2014. It must contain all of the following elements:

1. specific facts showing the necessity of the employment;
2. the name of the person to be employed;
3. the reasons for the selection;
4. the professional services to be rendered;
5. any proposed arrangement for compensation; and
6. all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States Trustee, or any person employed in the Office of the United States Trustee.

Fed. R. Bankr. P. 2014 disclosure requirements are to be strictly construed. All facts that may have any bearing on the disinterestedness of a professional must be disclosed. It is the responsibility of the professional, not of the court, to ensure that all relevant connections have been brought to light. Failure to disclose relevant connections is an independent basis for the disallowance of fees or disqualification.

The best practice is for the professional to file an application for employment as soon as possible after the petition date or retention, whichever comes first, even though Rule 6003 does not permit the court to enter the order approving the retention in the first 21 days of the case absent "immediate and irreparable harm." Rule 6003 bars entry of the order in the first 21 days, not the filing of the application. Once the court enters the order, it can be effective as of the date of the employment application.

Professionals perform services at their peril before they file an application for employment. Any approval of employment seeking an effective date before the application was filed should be considered as a request for *nunc pro tunc* approval. Some circuits enforce a rule denying compensation to professionals for work done prior to the filing of an application for employment unless, as a matter of fundamental fairness, the court approves a *nunc pro tunc* application. Some courts limit entry of *nunc pro tunc* employment orders to extraordinary circumstances and not merely because the approval requirement was overlooked. Mere oversight and inadvertence of counsel are not extraordinary circumstances.

Courts permitting a liberal *nunc pro tunc* approach generally consider if:

1. the application would have been approved originally by the court;

2. evidence appears in the record that demonstrates that the court and other interested parties had actual knowledge of the services being rendered;

3. an application seeking an order *nunc pro tunc* has been filed as soon as the matter is brought to the applicant's attention; and

4. a sustainable objection has not been filed to the application for fees.

The United States Trustee should enforce the requirement of prior court approval and object to the entry of *nunc pro tunc* orders, if appropriate.

3-7.1.1 Retention of Crisis Managers under 11 U.S.C. § 363

In some cases, the debtor may seek to retain a crisis manager, restructuring adviser, or chief restructuring officer (collectively, "crisis manager"). Although the specific terms of the retention and duties of these persons will vary from case to case, the hallmark of such engagements is that the crisis manager predominantly will assume duties that, outside of bankruptcy, typically would be performed by an officer or full-time employee of the debtor.

Because the nature of the crisis manager's duties arguably renders him or her non-disinterested, and therefore ineligible to be retained as a professional under section 327, debtors frequently seek to authorize the employment of such persons as a non-ordinary course transaction under section 363(b).

Although the USTP has never conceded that crisis managers fall outside the scope of section 327, which governs the retention of professionals, it has been the policy of the USTP not to object to applications to retain crisis managers under section 363(b) as long as certain conditions are observed. These conditions are memorialized in the *Jay Alix Protocol*, a 2003 stipulation between the United States Trustee for Region 3 and a crisis manager.

Among other key terms, the *Jay Alix Protocol* requires the crisis manager to limit itself to a single function in the bankruptcy case. The crisis manager may not fully supplant the debtor's existing management, but must remain answerable to the debtor's independent board of directors. In addition, the *Jay Alix Protocol* requires the crisis manager to file fee applications under procedures similar to those applicable to professionals under section 330 and limits the indemnification rights that the crisis manager's firm may receive. An individual crisis manager may be indemnified to the same extent as state law, the bylaws or other documents of corporate governance permit the indemnification of individual officers or directors, along with insurance coverage under the debtor's D&O policy The firm or corporate entity for which the crisis manager works may not be indemnified. The *Jay Alix Protocol* does not have the force of law. Rather, it is a compromise that the USTP historically has offered to debtors and crisis managers. As a result, if the debtor or crisis manager rejects any term of the *Jay Alix Protocol*, the United States Trustee retains the right to object to all issues regarding the crisis manager's employment, including the request to be retained under section 363 rather than section 327.

3-7.1.2 11 U.S.C. § 329 and Fed. R. Bankr. P. 2016(b) and 2017

Every attorney for a debtor must file the statement required by section 329 within 14 days of the order for relief setting forth the compensation paid or agreed to be paid for services rendered or to be rendered in contemplation of or in connection with the bankruptcy case and the source of such compensation. Fed. R. Bankr. P. 2016(b) also requires disclosure of any agreement to share compensation with any other entity, other than a member or regular associate of the attorney's law firm. Fed. R. Bankr. P. 2017 permits the court on the motion of a party in interest or on its own initiative to determine whether any payment or transfer to an attorney is excessive. Pursuant to section 329(b), the court may order the return of any excessive payments to the estate or the entity that made the payment.

3-7.1.3 Definition of Professional Person

Professional persons employed pursuant to section 327 or 1103 may be awarded compensation pursuant to sections 330 and 331. Clearly, the statute recognizes that attorneys, accountants, appraisers, and auctioneers are professional persons for whom prior court approval of employment would be required. Occasionally, it is necessary for the trustee, debtor in possession, or committee to contract with outside firms or individuals who do not fall within these categories for assistance in the performance of their statutory duties. In these circumstances, the question sometimes arises whether an order of employment is required. The classic definition of professional person for purposes of section 327(a) limits the term to "persons in those occupations which play a central role in the administration of the debtor proceeding." *In re Marion Carefree Ltd. Partnership*, 171 B.R 584 (Bankr.

N.D. Ohio 1994); *In re Seatrain Lines, Inc.*, 13 B.R. 980, 981 (Bankr. S.D.N.Y. 1981). The degree of autonomy and discretion exercised by the firm or individual in question is also a relevant consideration in determining whether the requirements of section 327(a) apply. *In re Bicoastal Corp.*, 149 B.R. 216 (Bankr. M.D. Fla. 1993); *In re Park Ave. Partners Ltd. Partnership*, 95 B.R. 605 (Bankr. E.D. Wis. 1988).

3-7.1.4 Auctioneers and Appraisers

The court must approve the retention of appraisers and auctioneers who must meet the same statutory requirements as other professionals. 11 U.S.C. § 327(a). Fed. R. Bankr. P. 6005 requires that the order of retention fix the amount or rate of compensation. The rule further provides that no employee or officer of the judiciary or of the Department may act as an appraiser or auctioneer, and provides that no residence or licensing requirement is to be required, even though most states require an auctioneer to be licensed and bonded. It is not unusual for an appraiser to be compensated on a per diem basis and an auctioneer to be compensated at a percentage of the gross proceeds of sale. Local rules may govern the maximum allowable percentage to auctioneers. The appraiser and the auctioneer should not be the same person. An obvious conflict arises where the same person appraises items that he or she will be auctioning, and the United States Trustee should object if it is proposed that one person be employed in both capacities.

Auctioneers must be bonded since they handle significant amounts of cash belonging to estates. The amount may be set by local rules, but the United States Trustee should require a bond of an amount sufficient to protect the estate. The bonds are generally filed with the clerk of the court. All proceeds of an auction sale are to be delivered to the trustee or the attorney for the debtor in possession as soon as they are received.

All auction sales are to be noticed pursuant to Fed. R. Bankr. P. 6004(a), and the auctioneer must submit an itemized statement of the property sold, the name of each purchaser, and the price received. Fed. R. Bankr. P. 6004(f)(1).

3-7.1.5 11 U.S.C. § 327(e)

An attorney who may be ineligible for employment under section 327(a) because of the attorney's prior representation of the debtor may be hired under section 327(e) if the employment is for a specified special purpose, other than general conduct of the case, provided that the employment is in the best interest of the estate and the attorney does not hold or represent an interest adverse to the estate with respect to the particular matter for which such attorney is employed. Note that section 327(e) applies only to attorneys. Accountants and other professional persons are not eligible for employment pursuant to that section.

An analysis of whether special counsel qualifies for employment under section 327(e) should begin with an understanding of applicable ethical regulations. Certain potential conflicts are capable of being waived after full disclosure and consent. Most often, the question will become whether the conflicting interest that makes counsel ineligible for employment under section 327(a) is such that counsel is rendered incapable of exercising independent professional judgment on behalf of the client. If the employment necessarily requires that one interest be served at the expense of the other, an adverse interest exists that should disqualify counsel for employment pursuant to section 327(e).

3-7.2 THE DISINTERESTED PERSON REQUIREMENT FOR EMPLOYMENT OF PROFESSIONALS AND APPOINTMENT OF TRUSTEES AND EXAMINERS

The disinterested person requirement of the Bankruptcy Code applies when professionals are employed pursuant to 11 U.S.C. § 327(a), and in the appointment of trustees and examiners, 11 U.S.C. §§ 701, 1104, 1202(a), and 1302(a).

3-7.2.1 Statutory Framework: 11 U.S.C. §§ 101(14) and 327(a)

"Disinterested person" is defined at section 101(14) as a person that:

(A) is not a creditor, an equity security holder, or an insider;

(B) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor; and

(C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or for any other reason.

Section 327(a) of the Bankruptcy Code involves the application of a two-pronged test. First, the professional must be disinterested as defined in section 101(14). Second, the professional must not hold or represent an interest adverse to the estate. Failure to meet either condition of employment can result in disqualification.

3-7.2.2 11 U.S.C. § 101(14)(A)-(B)

The language of section 101(14)(A)-(B) mandates a literal approach to the disinterested person requirement and sets forth in detail a series of characteristics

that disqualify a person from being "disinterested." These paragraphs do not call for any "weighing" or "balancing" of the impact of disqualification. A judicial determination that a person's characteristics would pose problems for the administration of the bankruptcy estate is not a prerequisite for disqualification. Each paragraph refers to characteristics of a person that are either carefully defined within the Bankruptcy Code or are easily understood. See, e.g., 11 U.S.C.§ 101(10) ("creditor"), (17) ("equity security holder"), and (31) ("insider"). If a professional has the characteristic, then disqualification is automatic. The fact that the interest in question may arguably be considered *de minimus* is of no importance in the analysis. Since the language of the statute is clear, it must be applied as written.

An agreement to subordinate a claim to payment of all other claims in a case will not cure a disinterestedness problem. However, waiver of the claim will render an applicant disinterested and thus in compliance with the statute.

3-7.2.3 Overlap of 11 U.S.C. § 101(14)(C) and 11 U.S.C. § 327(a)

A more difficult inquiry must be undertaken to determine whether the professional meets the adverse interest standard of sections 101(14)(C) and 327(a). Subparagraph (C) of section 101(14), the so-called "catch-all" provision, provides that a person is disinterested if the person:

> does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or for any other reason.

Section 327(a) provides that the trustee may employ professionals "that do not hold or represent an interest adverse to the estate, and that are disinterested persons. . . ." There is thus some overlap between the no adverse interest requirement of section 327(a) and the materially adverse interest standard of section 101(14)(C). Viewed practically, persons failing one of the requirements will often fail the other as well.

The conclusion that retention is improper requires a careful consideration and weighing of the totality of the circumstances presented; it is not, however, a balance of impropriety against the alleged disruption disqualification will create. If the circumstances reveal a conflict impeding the exercise of independent judgment by the professional, an objection to the retention should be made.

There are differences between sections 327(a) and 101(14)(C). Section 327(a) refers merely to an interest that is "adverse," whereas section 101(14)(C) refers to a "materially adverse" interest. This would suggest that a somewhat broader standard is contained in section 327(a). Subparagraph (C) of section 101(14),

however, appears to be more stringent than section 327(a) in one regard. The adverse interest clause of section 327(a) merely precludes the employment of persons holding or representing an interest adverse to the estate, whereas subparagraph (c) expands the proscription to include interests that are materially adverse not only to the estate, but also to any class of creditors or equity security holders.

These statutory distinctions complicate the analysis that must be undertaken. Further complexity results from the provision of section 327(c) that states that a professional is not disqualified for employment "solely because of such person's employment by or representation of a creditor, unless there is an objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest." Thus, a professional is not ineligible for employment simply because he/she represents a creditor, absent an actual conflict. Furthermore, section 1107(b) provides that, notwithstanding the requirements of section 327(a), a person is not disqualified for employment by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case. Proper application of these varied statutory provisions demands a painstaking analysis of the unique facts and circumstances presented in each case.

3-7.3 SPECIAL PROBLEMS IN RELATED CASES

3-7.3.1 Appointment of a Trustee

A trustee appointed in a chapter 11 case must meet the disinterested person requirement. 11 U.S.C. § 1104(d). Notwithstanding this requirement, when multi-debtor partnerships or related corporate debtors are involved, the responsibilities of the trustee to pursue assets and resist claims within the context of these entities may raise added concerns about potential conflicts. The determination of whether one or more trustees should be appointed in these circumstances rests upon a careful evaluation of the overall potential for conflict, i.e., the need for the varied interests involved in the cases to be separately administered.

The definition of a disinterested person proscribes various types of disqualifying interests. As a general matter, section 101(14) does not disqualify persons because of whom they represent, but rather because of the nature of their personal status – for example, because they personally are creditors of the debtor or they personally "have an interest" that is "materially adverse" under subparagraph (C). Therefore, the mere fact that a trustee may assert a claim against one estate in his or her representative capacity for another estate does not make him or her a "creditor" in an individual sense for purposes of applying 11 U.S.C. § 101(14)(A). *In re BH & P, Inc.*, 949 F.2d 1300 (3d Cir. 1991).

Moreover, the "materially adverse" requirement of section 101(14)(C) should not be read to prevent a single trustee from serving in related cases. A standard that automatically disqualifies a trustee from serving in jointly administered cases where there are inter-debtor claims is overbroad. Indeed, the provisions of Fed. R. Bankr. P. 2009 specifically allow the appointment of a single trustee for jointly administered cases. The United States Trustee must weigh a number of competing interests when deciding whether a single trustee can serve in such cases. A single trustee is often able to maximize the return to jointly administered estates through increased economy and efficiency. Moreover, jointly administered estates will virtually always have inter-debtor claims or potential claims. Were the use of a single trustee precluded in jointly administered estates, these cases would be exposed to increased costs and inefficiency. *In re BH & P, Inc.*, 949 F.2d 1300 (3d Cir. 1991).

However, there are circumstances where the appointment of one trustee in multiple cases may be inappropriate. Fulfilling fiduciary obligations to one estate may require that the trustee take actions that adversely impact the others. Genuine conflicts may arise. The presence and size of assets to pursue in the related estates, the disputed nature of the claims, and the relationship of the various classes of unsecured creditors must be examined. The issue to be resolved is whether the need for advocating competing interests among and between the estates is such that it interferes with the ability of the trustee to exercise independent judgment on behalf of one or more class of creditors. If creditors of the different estates will be prejudiced by conflicts of interest of a common trustee, the court should order the appointment of separate trustees for jointly administered cases. See Fed. R. Bankr. P. 2009.

There are related corporate debtor circumstances where multiple representation by trustees is allowed. The case of *In re O.P.M. Leasing Services, Inc.*, 16 B.R. 932 (Bankr. S.D.N.Y. 1982), is illustrative. In *O.P.M.*, a single trustee was appointed for two related debtors, a parent company and its subsidiary, in reorganization cases under chapter 11. Notably, different trustees had been appointed for the individual owners of the parent company in their liquidation cases. Objections were made to the multiple representation at late points in the cases during contested adversary proceedings between the corporate debtors and individual stockholders. The bankruptcy court found that the corporate debtors possessed a decisive "unity of interest and singleness of purpose" in prevailing in the adversary proceedings against the individual shareholders, even though there was a potential conflict between the parent and the subsidiary as to their respective rights to share in proceeds of the litigation and even though there were other inter-corporate claims. *In re O.P.M.*, 16 B.R. at 938.

In cases involving multiple representation of related debtors, steps can be taken to cure conflicts. The *O.P.M.* court noted that the potential conflict regarding the

debtors' respective rights to litigation proceeds did not require the appointment of different trustees because apparent conflicts of interest "might be resolved in a number of ways," including the appointment of special counsel. *In re O.P.M.*, 16 B.R. at 939 (quoting *In re General Economics Corp.*, 360 F.2d 762, 766 (2d Cir. 1966)). The appointment of separate or special counsel has been endorsed by several courts as an acceptable remedial measure.

O.P.M. illustrates the pragmatic approach of having a single trustee administer related debtor cases with inter-affiliate claims, particularly where an objection is raised late in the case. The issue is resolved by balancing the degree to which the circumstances interfere with the ability of the trustee to provide independent judgment against the impact that disqualification will have on the administration of the estate. The reality of the circumstances must be examined, not the hypothetical. Consideration must be given to the economic costs of appointing different trustees.

Finally, to the extent the United States Trustee decides to appoint one trustee, the trustee must be made aware of his or her own independent obligation to be on the outlook for any real or apparent conflicts and to make such disclosure or to take whatever steps are necessary and appropriate.

3-7.3.2 Retention of Professionals

In related cases, the professional's representation of all the debtors ultimately depends upon whether the professional's capacity for independent judgment and the vigorous pursuit of the interests of a particular debtor are infringed upon. As with the case of the multiple debtor trustee, the cost of obtaining different professionals, as well as the expense that accrues when a professional is employed late in a case, are significant factors. The nature of disclosure at the time of retention, whether the interests of related estates are parallel or conflicting, and the type of the inter-debtor claims are also significant. The size and nature of inter-debtor claims, whether they are disputed or hold priority status, and whether the various debtor interests diverge in some material way must also be examined. Ultimately, the efficiency and economy that favors multiple representation must be weighed against the need that the interests of each of the estates be adequately represented.

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On Our Watch

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Taking the Mystery Out of the Ch. 11 Trustee Appointment Process

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Every chapter 11 debtor becomes a debtor in possession, vested with most of the powers and duties of a trustee. In a careful compromise when adopting the Bankruptcy Code in 1978, Congress provided an alternative in cases where a debtor cannot or should not be vested with those trustee powers and duties: a chapter 11 trustee.[1] Although the Senate originally proposed that chapter 11 trustees be mandatory for all large cases, § 1104(a) of the Bankruptcy Code reflects the congressional compromise that bankruptcy courts must direct the U.S. Trustee to appoint a chapter 11 trustee if the court finds "cause" or that a trustee is in the interest of stakeholders.[2] In keeping with the Code's animating principle to separate the adjudication function from the enforcement and administration functions, the appointment itself is left to the impartial U.S. Trustee after "consultation with parties in interest."

Some commentators, including these authors, believe that greater use of the chapter 11 trustee mechanism to supplant management that cannot or will not act as fiduciaries on behalf of all stakeholders in the case would enhance sound corporate governance in bankruptcy.[3] Nevertheless, the appointment of a trustee should not be routine and requires great care.[4] This article will explain how U.S. Trustees approach this task through a comprehensive consultation and selection process to fulfill statutory obligations to select qualified and independent fiduciaries to represent the interests of all stakeholders in the chapter 11 case.[5]

The Consultation and Candidate Identification Process

Once the court orders the appointment of a chapter 11 trustee, the U.S. Trustee, after consultation with parties in interest, appoints a disinterested person. This trustee appointment is subject to court approval.[6]

U.S. Trustees approach the consultation and appointment process seriously. The U.S. Trustee Program (USTP) has developed thorough and rigorous processes, scaled to the needs of the case, to ensure a comprehensive search for and evaluation of the best candidates. Although a U.S. Trustee will never enter into an agreement to appoint a particular candidate, U.S. Trustees often encourage parties to begin considering skills and candidates before the court orders the appointment. Once the court enters the order, the U.S. Trustee expeditiously consults with major creditors, the creditors' committee, the debtor and other interested parties. This consultation might be in person, by telephone or by email. U.S. Trustees place a high value on the input provided by parties in interest.

During these consultations, parties occasionally recommend more than one candidate to the U.S. Trustee and may advise the U.S. Trustee of their first choice. An unsuccessful candidate may think

1 11 U.S.C. § 1104(a). For additional information on congressional deliberations leading to the adoption of the Bankruptcy Code, *see* Clifford J. White III and Walter W. Theus, Jr., "Chapter 11 Trustees and Examiners after BAPCPA," 80 *Am. Bankr. L. J.* 289, 293-97 (2006).

2 11 U.S.C. § 1104(a).

3 Charles J. Tabb, "The Future of Chapter 11," 44 *S.C. L. Rev.* 791, 857 (1992-93) ("Under the Code, trustees are almost never appointed.... Courts announce and apply a very strong presumption against the appointment of a trustee. The norm is that the debtor continues in possession. This ... is a perversion of what virtually everyone involved in the 1970s reforms intended.").

4 There are many reasons for the reluctance of parties to seek chapter 11 trustees. These include historical reluctance to oust entrenched management that pre-dates the changes to the Bankruptcy Code conferring the authority on the U.S. Trustee to make the appointment. Some courts apply an arguably unjustified burden of proof ("clear and convincing evidence" vs. "preponderance of the evidence") before granting a chapter 11 trustee motion. Creditors may wish to avoid possible retaliation by the incumbent management and its creditor allies. Some of the more powerful players in the case may also be concerned that they will lose control of the case and risk possible investigation into estate claims against them.

5 In contrast, conversion of a case from chapter 11 to a chapter 7 liquidation with a trustee appointed from the U.S. Trustee's statutory panel of chapter 7 trustees is not rare. The U.S. Trustee files a motion to convert or dismiss in about 40 percent of all chapter 11 cases. The motions are typically filed in smaller cases and on such grounds as negative cash flow diminishing the value of the estate, the failure to maintain insurance or the failure to file required financial reports. *See* 11 U.S.C. § 1112(b)(4).

6 11 U.S.C. § 1104(d); *see also* Fed. R. Bankr. P. 2007.1.

that the U.S. Trustee has rejected the creditor's recommendation, wrongly believing that he/she was the creditor's first or only choice.

In addition to names of particular individuals, the U.S. Trustee seeks the interested parties' views of the "skill set" that the trustee should possess. In some cases, a businessperson with expertise in dealing with distressed companies in the relevant industry might be the best choice. In others, an attorney with significant experience handling complex financial litigation might be better suited, or a person with a background in the investigation of financial fraud might be more ideal.[7]

The U.S. Trustee also brings independent judgment to bear on what type of trustee the case needs and what person is best qualified to serve as trustee. The U.S. Trustee encourages and considers self-nominations to expand the pool of qualified and independent candidates. Unlike in chapter 7,[8] the U.S. Trustee can also conduct a nationwide search for a chapter 11 trustee. In the most complex cases, the U.S. Trustee often reaches beyond the district in which the case was filed to identify candidates with unquestioned independence and the optimum skill set to best meet the needs of the case.

Professionals occasionally request meetings with senior USTP officials to discuss their qualifications and interest in future appointments. Such meetings, which are held at the headquarters or in regional offices, are welcomed and valuable. They are often scheduled to permit the attendance of multiple U.S. Trustees in person, by video or telephone conference. These prior meetings provide a good source of candidates to whom the U.S. Trustee may reach out, even if the candidate was not recommended by a creditor in the case at bar. The USTP urges bankruptcy and other professionals to request such meetings to strengthen the bench of potential candidates for future appointments, particularly in cases in which the need for a speedy appointment is most acute.

The Appointment Decision

In considering whom to appoint, U.S. Trustees first look for independence. A candidate cannot be beholden to the party that recommended him/her or to any other party in the case. The trustee must protect all interests and be prepared to "bite the hand that fed" him/her if required. For example, an attorney for a major creditor recently complained about the selection of a chapter 11 trustee who aggressively pursued causes of action against his client, notwithstanding the irony that his client had recommended the trustee to the U.S. Trustee. That trustee displayed admirable independence. The U.S. Trustee's impartiality in appointing trustees enhances trustees' ability to exercise this type of independence.

Beyond independence, the U.S. Trustee will consider a candidate's experience, qualifications and ability to muster necessary bankruptcy, financial and business expertise. The U.S. Trustee might have an informed view about the ideal skill set for the engagement. For example, a debtor might be an operating business and the U.S. Trustee and parties might agree that a turnaround specialist would be ideal for the position. The U.S. Trustee will seek to ensure that the specialist will engage the proper professionals and take appropriate steps to manage the costs of case administration.

How is this information gathered? The U.S. Trustee seeks CVs or résumés from recommended and self-nominated candidates. The U.S. Trustee may also request that candidates complete a preliminary conflict analysis and submit preliminary statements of their connections with a debtor, its insiders and creditors before a final, more rigorous review. In many cases, and certainly in every complex one, the U.S. Trustee will interview candidates before making the appointment. Candidates are interviewed by phone or in person, and might be interviewed more than once. The U.S. Trustee and others from the USTP will question the candidate about a broad range of topics, such as the candidate's expertise and amount of time available to devote to the job. In particular, the questions often focus on the candidate's prior experience in similar matters; how the candidate would economically assemble a team to address the multi-faceted aspect of a case; the candidate's knowledge of the case, including how that knowledge was obtained; and the candidate's initial plan to marshal assets and secure information to guide the case to a successful conclusion.

In-person interviews are strongly preferred, but the urgency of an appointment sometimes requires that interviews be conducted by videoconference or telephone. In major cases, it is not unusual for a multi-regional team, including Executive Office officials, to interview candidates along with the selecting U.S. Trustee. This enhances the thoroughness of the evaluation process in the particular case and helps acquaint a wider swath of USTP officials who are involved in the trustee appointment process with an array of candidates for consideration in future cases.

Reviewing conflicts and connections is often the most important and painstaking stage of the appointment process. Additional disclosures are often requested, and assessing connections, particularly in larger cases with candidates from large professional firms, can be difficult. Disqualifying conflicts are not always obvious. Often, a candidate who was tentatively selected is not appointed after a full review of his/her connections with the case and stakeholders. Although "conflicts counsel" may sometimes be countenanced to deal with limited attorney conflicts, "conflicts trustees" never can. A trustee must be "disinterested," but that is not the end of the inquiry. We seek to appoint trustees whose objectivity and independence is beyond question. For example, a candidate from a law firm, although technically disinterested and legally eligible to serve personally, may nevertheless be deemed unsuitable for appointment as a fiduciary because of the firm's representations or relationships in unrelated matters.[9]

Once the U.S. Trustee decides who to appoint, the appointment and approval process is relatively straightforward. The U.S. Trustee formally appoints the candidate and then files an application seeking approval of the appointment.

7 In smaller cases or cases where an immediate liquidation appears likely, parties frequently suggest that the U.S. Trustee appoint members of the chapter 7 panel of trustees to serve as chapter 11 trustees, recognizing the expertise of those persons in bankruptcy matters.

8 11 U.S.C. § 321(a)(1) (chapter 7 trustee must reside or have office in judicial district where case is pending or in adjacent district).

9 Chapter 11 trustees are also subject to a government background investigation, similar to the process conducted for federal employment. This formal investigation generally involves filling out a detailed background questionnaire, followed by a public records search and field investigation. The background investigation process is usually completed after the appointment is effective. In rare cases, it has been necessary to withdraw the selection of a candidate due to information revealed on the background questionnaire or to seek the removal of a trustee after appointment.

Pursuant to Rule 2007.1,[10] the application must name the trustee and the trustee's connections with parties in interest, their attorneys and accountants, the U.S. Trustee and persons employed by the U.S. Trustee. The application must also list the parties with whom the U.S. Trustee consulted in connection with the appointment. A statement of connections verified by the appointee will be attached to the application. The court's approval of the appointment should be limited to a review of whether the person is statutorily qualified to serve; the court should not substitute its judgment for that of the U.S. Trustee.

The final check on the trustee appointment process is the right of creditors to seek a trustee election,[11] which is rarely invoked. The U.S. Trustee will not delay appointing a trustee until the time for an election request has expired, because the circumstances justifying the removal of management generally call for quick action.

Conclusion

The Bankruptcy Code provides a straightforward mechanism to supplant managers who are unsuitable to serve in a fiduciary capacity for all stakeholders. The Code also provides standards and procedures that are assiduously followed by U.S. Trustees in selecting qualified and independent candidates. U.S. Trustees have appointed highly qualified individuals to serve as trustees and examiners[12] in chapter 11 cases, including top bankruptcy partners from major law firms, nationally known workout and turnaround professionals, financial professionals, retired bankruptcy judges, a former director of the Federal Bureau of Investigation and other former high-ranking law enforcement officials. Perhaps more discussion of the need for chapter 11 trustees and less mystery surrounding the selection process can lead to more diligent use of this important tool for sound corporate governance in bankruptcy cases. abi

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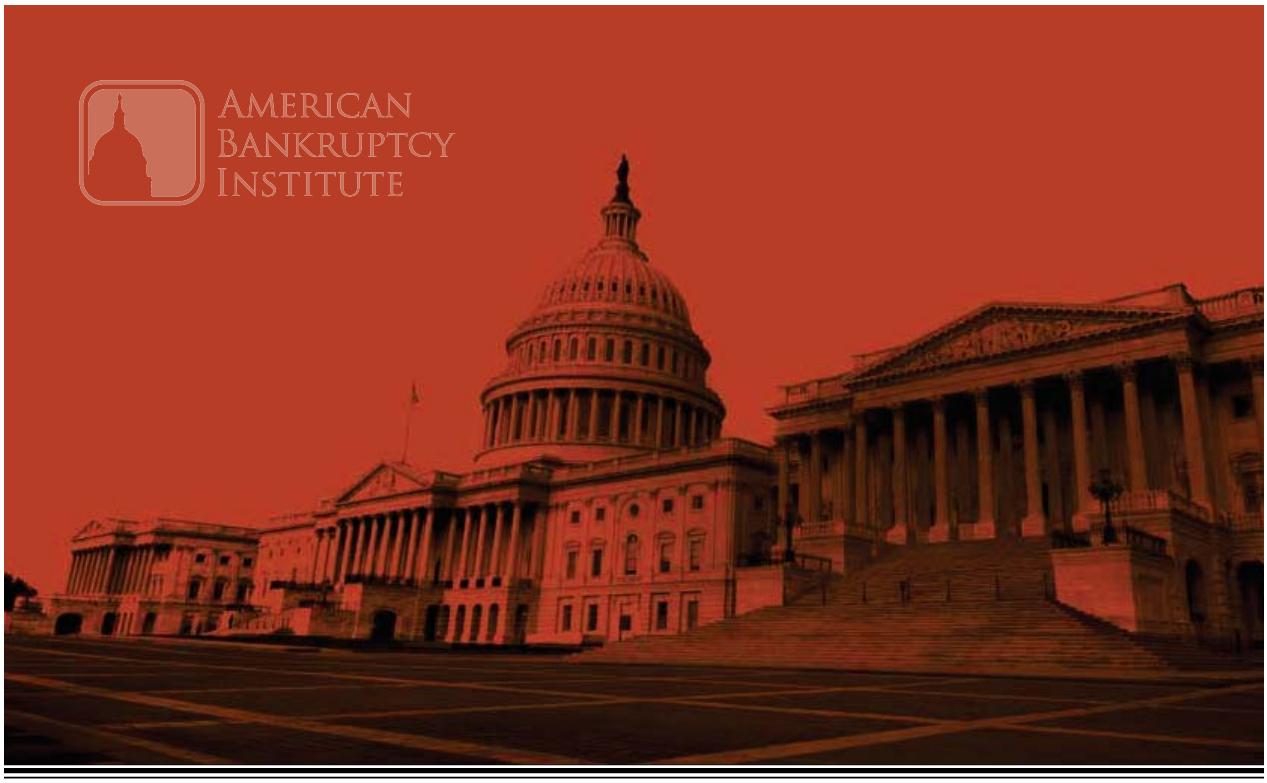
10 Fed. R. Bankr. P. 2007.1.
11 11 U.S.C. § 1104(b).
12 The process for appointing examiners is identical to that for appointing trustees. 11 U.S.C. § 1104(d).



AMERICAN BANKRUPTCY INSTITUTE

COMMISSION TO STUDY THE REFORM OF CHAPTER 11

2012~2014

FINAL REPORT AND RECOMMENDATIONS

SPONSORED BY THE ANTHONY H.N. SCHNELLING ENDOWMENT FUND

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2. The Chapter 11 Trustee

Recommended Principles:

- The standard for appointing a chapter 11 trustee under section 1104(a) of the Bankruptcy Code should not change.
- The burden of proof with respect to requests for the appointment of a chapter 11 trustee under section 1104(a) should be based on the preponderance of the evidence standard. Case law requiring application of the clear and convincing standard should be overturned by statutory amendment.
- As is currently provided by section 1104(d), the U.S. Trustee should continue to select and appoint a disinterested person to serve as chapter 11 trustee after the court enters an order under section 1104(a) directing such appointment and after consultation with parties in interest.[94]
- A party in interest should be able to object to the person appointed as the chapter 11 trustee. An objecting party should plead with particularity the facts supporting its objection. The objection should be filed and heard on an expedited basis. The court should approve the person appointed by the U.S. Trustee unless the objecting party establishes by clear and convincing evidence that: (1) the U.S. Trustee did not properly consult with parties in interest; (2) the person selected is not eligible to serve as trustee under section 321; (3) the person selected has not qualified to serve as trustee under section 322; (4) the person selected is not disinterested; or (5) the person selected has a disqualifying conflict of interest. If an objection is filed, the court should approve or disapprove the person appointed as chapter 11 trustee by the U.S. Trustee, but the court should not otherwise be involved in the chapter 11 trustee selection process.
- Section 1104(b), which provides for the election of a chapter 11 trustee, should be deleted.
- Once appointed, the chapter 11 trustee may take any actions and exercise any powers with respect to the estate as authorized under section 1106 without the approval or consent of the debtor, the debtor's board of directors (or similar governing body), any of the debtor's officers or similar managing persons, or the debtor's equity security holders.
- The appointment of a chapter 11 trustee should not terminate the debtor's exclusivity period to file, or its time to solicit acceptances of, a plan, but should preserve such exclusivity period solely for the benefit of the trustee. Accordingly, the trustee should receive the benefit of any remaining exclusivity period under section 1121, provided that a party in interest should be able to file a motion seeking to shorten or terminate such period as provided in section 1121(d). Section 1121(c)(1) should be amended accordingly.

94 Bankruptcy cases in Alabama and North Carolina are not under the jurisdiction of the U.S. Trustee, but rather are administrated by Bankruptcy Administrators in those jurisdictions. Accordingly, the applicable rules of those jurisdictions would govern the appointment process.

The Chapter 11 Trustee: Background

A trustee is appointed in a chapter 11 case only upon a motion of a party in interest or the U.S. Trustee and the entry of an order of the court granting such motion. Section 1104 of the Bankruptcy Code provides that the court shall order the appointment of a trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management" or "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate."[95] In addition, section 1104(e) requires the U.S. Trustee to file a motion requesting a trustee "if there are reasonable grounds to suspect that current [management] . . . participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting."[96]

Notwithstanding this statutory authority, anecdotal evidence suggests that chapter 11 trustees are the rare exception rather than the rule.[97] The paucity of cases in which chapter 11 trustees serve may suggest that the overall system is working and that stakeholders either have confidence in the debtor's management or have replaced troublesome managers prior to or shortly after the petition date.[98] Parties in interest may also be using the possibility of seeking the appointment of a trustee in negotiations with the debtor in a way that fosters meaningful results and eliminates the need for a trustee.[99] A case warranting a chapter 7 trustee may convert to a case under chapter 7 of the Bankruptcy Code, thereby eliminating the need for a chapter 11 trustee.[100] Some contend that a systemic antipathy to reorganization trustees, arising from pre-Bankruptcy Code practice, found its way into early decisions that construed the language of the Bankruptcy Code.[101] For example, courts may be discouraging parties from filing motions requesting the appointment of a chapter 11 trustee by applying the clear and convincing standard to the determination.[102] Parties in interest also may fear retribution by the debtor or other stakeholders if the court denies the motion, or may prefer having individuals with whom they are familiar (even if they do not like or necessarily trust them) rather than an individual they do not know. Moreover, some parties may raise concerns regarding the costs associated with chapter 11 trustees, which may be driven by a perception that chapter 11 trustees are inclined toward litigation to ensure that they fulfill their fiduciary duties to the estate.[103]

If the court enters an order appointing a chapter 11 trustee, the U.S. Trustee identifies a disinterested and qualified individual to serve as the trustee.[104] Section 1104(d) requires the U.S. Trustee to

95 11 U.S.C. § 1104(a)(1), (2).
96 *Id.* § 1104(e).
97 *See, e.g.,* Dickerson, *supra* note 19, at 888–900 (explaining that "[t]hough the Code provides that managers can be replaced or supervised by a public trustee, trustee appointments are, and always have been, rare"); Kelli A. Alces, *Enforcing Corporate Fiduciary Duties in Bankruptcy*, 56 U. Kan. L. Rev. 83, 84–85 (2007) (noting rarity of chapter 11 trustees).
98 *See, e.g.,* John D. Ayer, et al., *Bad Words to a Debtor's Ear*, Am. Bankr. Inst. J., Mar. 2005, at 20 ("Creditors force out the old management before the chapter 11 begins, and so the nominal 'DIP' is someone in whom creditors have faith, sent in to clean up the mess that others left behind.").
99 *See, e.g.,* Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 Wash. U. L.Q. 1005, 1012 (1994) (discussing creditors' threats to petition the court to appoint a trustee if managers do not resign).
100 *See, e.g.,* Ayer et al., *supra* note 98.
101 Clifford J. White III & Walter W. Theus, Jr., *Chapter 11 Trustees and Examiners after BAPCPA*, 80 Am. Bankr. L. J. 289, 314–15 (2006).
102 *See, e.g., In re* G-I Holdings, Inc., 385 F.3d 313 (3d Cir. 2004) (applying clear and convincing standard). *But see* Tradex Corp. v. Morse, 339 B.R. 823 (D. Mass. 2006) (applying preponderance of the evidence standard).
103 In addition, the increasing use of chief restructuring officers, at least in larger chapter 11 cases, may suggest that parties are working around the concerns often associated with chapter 11 trustees.
104 *See* Clifford J. White III & Walter W. Theus, Jr., *Taking the Mystery Out of the Chapter 11 Trustee Appointment Process,* Am. Bankr. Inst. J, May 2014 ("Beyond independence, the U.S. Trustee will consider a candidate's experience, qualifications and ability to

consult with parties in interest during this process, and the selection is subject to court approval.[105] Although section 1104(d) is silent on the scope of court review, the court generally will review only whether the U.S. Trustee consulted with parties as required by the Bankruptcy Code and whether the candidate is disinterested and is formally qualified to serve as trustee. A party in interest may also request that the U.S. Trustee hold an election for the trustee in accordance with section 702 of the Bankruptcy Code.[106]

Once identified and approved, the chapter 11 trustee assumes all of the powers of the debtor's management, is vested with certain other powers, and is subject to certain duties under section 1106 of the Bankruptcy Code. The trustee can, among other things, operate the debtor's business, manage and administer the bankruptcy estate, file and implement a chapter 11 plan, and investigate the debtor's affairs and prepetition activities.[107] The trustee must also ensure that certain materials and reports are filed with the court on a timely basis.

The Chapter 11 Trustee: Recommendations and Findings

The debtor in possession model should not be the sole structure for a chapter 11 case. The Bankruptcy Code needs an effective mechanism for appointing a chapter 11 trustee to displace management in appropriate cases. The Commissioners discussed the kinds of cases that warrant chapter 11 trustees, including instances of fraud or illegal conduct by management. They also acknowledged the value of appointing a trustee to increase accountability in chapter 11 cases, to protect against "bankruptcy rings" and collusive conduct, and to create dynamic tension by introducing an outsider to the negotiation process.[108] As referenced in the previous section, however, the Commissioners also evaluated the potential disadvantages of appointing a trustee, such as the potential collateral impact of the appointment, additional costs, delays, and inefficiencies in the case. In light of the foregoing, the Commission determined to retain the grounds for the appointment of a chapter 11 trustee set forth in section 1104(a) because they are warranted and strike an appropriate balance between the benefits and drawbacks of such appointment.

The Commission also considered the relatively low percentage of trustee appointments in chapter 11 cases. It was not able to determine if the relatively small number of trustee appointments suggested a flaw in the current system or reflected the judgment of stakeholders that grounds either did not exist to support an appointment or were remedied through prepetition changes

muster necessary bankruptcy, financial and business expertise."). Bankruptcy cases in Alabama and North Carolina are not under the jurisdiction of the U.S. Trustee, but rather are administrated by Bankruptcy Administrators in those jurisdictions.

105 11 U.S.C. § 1104(a). *See also* Chapter 11 Trustee Handbook 7 (May 2004) (explaining that the U.S. Trustee consults, either by telephone or in person, with parties in interest to identify candidates and then interviews potential candidates to determine if they are qualified for the particular case and disinterested); White & Theus, *supra* note 104 ("Once the court enters the order, the U.S. Trustee expeditiously consults with major creditors, the creditors' committee, the debtor and other interested parties. This consultation might be in person, by telephone or by email. U.S. Trustees take seriously and place a high value on the input provided by parties in interest.").

106 11 U.S.C. § 1104(b) (providing that motion requesting an election must be filed within 30 days of the entry of the order appointing a chapter 11 trustee).

107 *Id.* § 1106(a).

108 For a historical overview of the purpose of the U.S. Trustee in response to so-called "bankruptcy rings," *see* 6 Collier On Bankruptcy ¶ 6.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.) ("[I]n many parts of the country, the Bankruptcy Act principle of creditor control of cases had degenerated into a system of attorney control. That fostered the development of 'bankruptcy rings,' closed bankruptcy practices heavily favoring the appointment of insiders, who were obliged to one another, to trustee positions. Cases were too often administered solely for the benefit of the members of the bankruptcy rings, with creditors receiving nothing.").

in management. The Commissioners were persuaded by the suggestion that the burden of proof governing a motion to appoint a chapter 11 trustee under section 1104 could influence the decision of a party in interest to file such a motion in the first place. Indeed, courts often expressly state that the appointment of a chapter 11 trustee is the exception and that the standard for approval is very high.[109] The Commissioners evaluated the potential chilling effect of requiring the moving party to demonstrate the need for a trustee by clear and convincing evidence and the justifications for this standard.[110] They also discussed whether a lower standard, such as the preponderance of the evidence standard, could be subject to abuse and cause unnecessary distractions in the chapter 11 case.

The Commissioners carefully weighed the competing considerations and relevant policy objectives underlying the debtor in possession model and the Bankruptcy Code. Reflecting on the discussion of cases that may warrant and benefit from a trustee, the Commission determined that the lower preponderance of the evidence standard — and not the clear and convincing evidence standard — should apply to motions to appoint a chapter 11 trustee under section 1104(a). This change is likely to not only encourage parties in interest to seek the appointment of a chapter 11 trustee in appropriate cases, but it would also resolve a split among the courts on this important legal issue.

The Commissioners also discussed their various experiences with trustees in chapter 11 cases and acknowledged that, particularly in cases involving massive fraud by the debtor, chapter 11 trustees have served with distinction.[111] They discussed the value of having the U.S. Trustee, as an independent agency with no financial stake in the case, identify and vet trustee candidates, because multiple stakeholders may have competing interests in the selection process.

The Commission reviewed at length the current consultation process and believed that the U.S. Trustee should, as under current law, continue to consult with parties in interest to both identify potential candidates and to better understand the needs and circumstances of the particular case. The Commission did not find any value in imposing a public meeting requirement on the trustee selection process; rather, all evidence indicates that the private consultation practice currently in place works well, and imposing a public meeting requirement is likely to add cost and delay to the process and to chill participation and openness.

The Commission considered whether the election process incorporated into section 1104(b) provides stakeholders with a sufficient alternative to a candidate selected by the U.S. Trustee. In theory, the election process should enable stakeholders to nominate directly and then to vote on

109 *See, e.g., In re* Taub, 427 B.R. 208, 225 (Bankr. E.D.N.Y. 2010) ("The appointment of a trustee is an unusual remedy and '[t]he standard for § 1104 appointment is very high. . . .'") (quoting Adams v. Marwil (*In re* Bayou Grp., LLC), 564 F.3d 541, 546 (2d Cir. 2009)).

110 *See, e.g., In re* LHC, LLC, 497 B.R. 281, 291 (Bankr. N.D. Ill. 2013) ("Applying the clear and convincing evidence standard appears . . . to be more consistent with the presumptions that a debtor should generally be permitted to remain in control and possession of its business and that the appointment of a Chapter 11 trustee is an extraordinary remedy.") (citation omitted).

111 *But see Written Statement of Daniel Kamensky on behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) ("MFA therefore suggests that Congress should make clear that parties in interest and the U.S. Trustee may seek appointment of a trustee in circumstances other than fraud – where management entrenchment, misalignment of interests or other factors have significantly impaired the reorganization process such that a neutral third party is necessary to break the logjam. Appointment of a trustee should be authorized if the court believes that a trustee will be better equipped than management to navigate competing interests and facilitate a successful reorganization. The preference of all creditors should be taken into account – both in the appointment of an interim trustee and in any subsequent election.").

qualified candidates. Unfortunately, the anecdotal evidence suggests that stakeholders rarely request an election process and are skeptical that the process benefits the estate for at least two reasons. First, it is hard to displace a trustee that has already been put in place, even if a different person with greater support among the constituents might have been picked in the first instance. Second, several of the major constituencies are not entitled to vote under section 1104(b), including secured creditors and unions.[112]

The Commissioners found the election process unsatisfactory in light of these concerns. Consequently, the Commission considered alternative ways to provide all stakeholders with a stronger voice in the trustee-selection process, based on the belief that such a process may further mitigate any resistance to trustee appointment in appropriate cases. The Commissioners discussed a variety of ways to allow stakeholders to voice objections to trustee candidates and to have some role in the selection process. In exploring these alternatives, the Commissioners were very mindful of the need for the U.S. Trustee to maintain flexibility and discretion as the independent appointing official. Allowing the court or stakeholders to second-guess the U.S. Trustee's decision too easily could come with substantial costs, including introducing bias into the process and paralyzing the debtor's reorganization efforts while parties in interest attempt to agree on a trustee candidate.

Section 1104(d) provides for court approval of the U.S. Trustee's trustee appointments, but does not specify any grounds upon which the court may disapprove an appointment. Furthermore, parties in interest are given no role in the appointment approval process. The Commission concluded that specifying grounds for disapproval and providing stakeholders with a more defined ability to object to the U.S. Trustee's appointment would be beneficial. The Commissioners explored how to discourage frivolous objections and to encourage full disclosure in a manner that informed the parties and the court about the issues relevant to the appointment of the trustee. The Commission determined that any objections should be pled with particularity and that the objection process should incorporate a strong presumption favoring the U.S. Trustee's candidate. The court should approve the person appointed by the U.S. Trustee unless the objecting party establishes by clear and convincing evidence that: (1) the U.S. Trustee did not properly consult with parties in interest; (2) the person selected is not eligible to serve as trustee under section 321 of the Bankruptcy Code; (3) the person selected has not qualified to serve as trustee under section 322 of the Bankruptcy Code; (4) the person selected is not disinterested; or (5) the person selected has a disqualifying conflict of interest. A court should not reject the U.S. Trustee's selection based on a party in interest's assertion that another individual would better serve the estate or is better qualified for the position. Moreover, neither the court nor the objecting party should be able to displace the U.S. Trustee in the appointment process. The court should only be able to approve or disapprove the U.S. Trustee's appointment. If the court disapproves an appointment, the U.S. Trustee should still maintain control of the appointment process by vetting additional candidates and making a substitute appointment.

Once a chapter 11 trustee has been appointed, the Commission found that the current process works for vesting the trustee with all control and management authority concerning the debtor and the estate. Specifically, if grounds exist to warrant the appointment, the chapter 11 trustee

112 Eligibility to vote for the trustee is determined by section 702 of the Bankruptcy Code. In order to vote, creditors must, among other things, hold an allowable undisputed, fixed, liquidated, and unsecured claim. Secured creditors are thus not eligible to vote because their claim is not unsecured, and unions are frequently not eligible to vote because their claims are contingent, disputed, or unliquidated.

should be able to take any actions and exercise any powers with respect to the estate as authorized under section 1106 without the approval or consent of the debtor, the debtor's board of directors (or similar governing body), any of the debtor's officers or similar managing persons, or the debtor's equity security holders. Accordingly, the chapter 11 trustee should, for example, be able to cause the estate to retain managers and employees deemed necessary to the reorganization process, but such personnel should act only under the supervision of the trustee.

The Commissioners debated whether the debtor's exclusivity periods to file a plan and solicit acceptances of a plan should terminate upon the appointment of a trustee. The Commissioners explored why termination may be appropriate; indeed, displacement of the debtor's management suggests a need for different approaches to the reorganization, and stakeholders should have some say in the new process. The trustee, however, is appointed in large part to facilitate this new direction and should have some ability to negotiate with the various stakeholders to try to reach a resolution that benefits the estate and its stakeholders. Accordingly, the Commission determined that if the debtor has any remaining exclusivity periods under section 1121 at the time of the trustee's appointment, the trustee should be able to step into the shoes of the debtor and receive the benefit of such remaining exclusivity periods, but should not be able to seek extensions of those periods.

In discussing the chapter 11 trustee appointment process, as well as the estate neutral appointment process described below, the Commission considered the current dual system for bankruptcy administration: (i) U.S. Trustees for 48 states, Puerto Rico, the U.S. Virgin Islands, and Guam; and (ii) Bankruptcy Administrators for Alabama and North Carolina. The Office of the U.S. Trustee operates as a division of the Department of Justice, and the Executive Office for U.S. Trustees coordinates and oversees the activities of the U.S. Trustees in 21 regional offices.[113] This structure promotes uniformity and consistency in the application of federal bankruptcy laws. The Bankruptcy Administrator programs are separately administered in each state through the judiciary in those states.[114]

The Commissioners debated the efficiency of continuing these two separate systems. Some Commissioners believed that unifying the administration and oversight of bankruptcy cases in all jurisdictions under the Office of the U.S. Trustee would promote the uniformity in the application of federal bankruptcy laws as envisioned by the Bankruptcy Clause of the Constitution[115] and would serve the interests of parties in the system. They encouraged the Commission to recommend making the U.S. Trustee program a national program that would be responsible for bankruptcy administration in all 50 states, as well as Puerto Rico, the U.S. Virgin Islands, and Guam. Other Commissioners expressed a concern that this issue was not directly within the scope of the Commission's mandate. Consequently, the Commission decided not to address this matter.

113 For more information about U.S. Trustees and the Executive Office for the U.S. Trustees, *see U.S. Trustee Program*, http://www.justice.gov/ust/index.htm.

114 For more information about Bankruptcy Administrators, *see Bankruptcy Administrators*, http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyAdministrators.aspx.

115 U.S. Const. art. I, § 8, cl.4. *See also* Charles Jordan Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, 2015 Ill. L. Rev. __, at *1 (forthcoming 2015) (noting that the powers granted to Congress under the Bankruptcy Clause are extremely broad), *available at* http://ssrn.com/abstract=2516841.